III. INTERNATIONAL ENVIRONMENT OF THE CENTRAL BANK'S ACTIVITIES

Eesti Pank's everyday work in conducting monetary policy, working out legislation regulating the banking sector activities, supporting the development of the financial sector infrastructure and macroeconomic analysis is closely linked with the relevant activities of our international partners and agreements between countries. Priorities of the European Union (EU), the International Monetary Fund (IMF) and other international organisations depend, in turn, on the political decisions made in the name of resolving the problems of the world economy or achieving the goals agreed upon. EU enlargement and the resulting possibilities and obligations concerning multilateral economic policy cooperation are undoubtedly among the most important processes affecting the environment of the central bank's activities in Estonia. However, Estonia's obligation to contribute to solving global issues and meet international agreements is not limited with the European Union. From the point of central bank's activities, the IMF is also an important cooperation partner.

RENEWING EUROPEAN UNION

Reunion of Eastern and Western Europe creates a need to achieve a new level of cooperation. The new, larger Europe has to be efficient, democratic, legally safe and understandable and open to all its citizens. In order to realise these expectations, the European Council adopted the Future of Europe Declaration at the Laeken summit in 2001 and formed the Future of Europe Convention for more efficient discussion. The Convention is attended by representatives from both current and prospective EU member countries. This is the first opportunity for candidate countries to participate in shaping EU policies equally with member countries. Substantial cooperation in the fields of economic and financial sector policies has taken place at various levels for a number of years already. It is no longer limited to reports on compliance with the principles of EU policies, but a new phase of cooperation has been reached. **After the signing of accession treaties in April 2003, Estonia and other accession countries have been invited to attend as observers in the work of the EU Council of Ministers and its substructures, the General Council of the European Central Bank and the committees of the European System of Central Banks.**

EU Enlargement

A major event of 2002 was the European Council's decision on 12–13 December in Copenhagen to conclude accession negotiations with ten candidate countries[1]**.** The signing of the accession treaty took

[1] Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia.

place on 16 April 2003 in Athens. After that, the treaty has to be ratified by the European Parliament and the parliaments of all EU members and accession countries. The ratification process has to be concluded so that the treaty could come into force on 1 May 2004 and enable the citizens of new member countries to participate in the elections to the European Parliament in June 2004.

Preparations for accession were based on membership criteria the European Council defined in 1993 in Copenhagen. Meeting these criteria and adoption of EU legislation[2] facilitated economic reforms in candidate countries, economic integration and increase of living standards. The economies of candidate countries are already closely linked with the EU common market: trade with EU countries accounts for half or even two thirds of the total foreign trade and the bulk of investments come from EU countries. Now, new opportunities will open for market development. Table 3.1 illustrates the living standards of candidate countries as compared to the EU average.

Table 3.1. Living standards of candidate countries and foreign trade integration with EU countries

Country	Population (million inhabitants)	GDP per capita in purchasing power standards			GDP change (%)	Foreign trade with EU countries (% of all foreign trade)	
		in euro	% of EU average				
		2001	2000	2001		Export	Import
Bulgaria	7.9	6,500	24	28	4.0	54.8	49.4
Cyprus	0.8	18,500	83	80	4.0	49.0	55.5
Czech Republic	10.2	13,300	60	57	3.3	68.9	61.8
Estonia	**1.4**	**9,800**	**38**	**42**	**5.0**	**69.4**	**56.5**
Hungary	10.2	11,900	52	51	3.8	74.3	57.8
Latvia	2.4	7,700	29	33	7.7	61.2	52.6
Lithuania	3.5	8,700	29	38	5.9	47.8	44.0
Malta	0.4	11,700[1]	55[1]	55[1]	-0.8	41.3	63.6
Poland	38.6	9,200	39	40	1.1	69.2	61.4
Romania	22.4	5,900	27	25	5.3	67.8	57.3
Slovakia	5.4	11,100	48	48	3.3	59.9	49.8
Slovenia	2.0	16,000	72	69	3.0	62.2	67.7

[1] The data for 1999
Source: European Commission

In 2002, economic policy dialogue between candidate countries and the EU structures continued and deepened on the level of the Economic and Financial Affairs Council (Ecofin) as well as the Economic and Financial Committee and its alternate members; the focus of the dialogue was on the pre-accession economic programmes of candidate countries. The fourth meeting of finance ministers took place on 5 November. In the meeting the sustainability of economic programmes was assessed and progress of candidate countries and future tasks in the field of economic stability and structural reforms discussed. High budget deficit in several candidate countries and inadequate deepening of the financial sector were pointed out as major problems.

Economic policy coordination continued also with the European Commission. In the framework of fiscal notification candidate countries informed the Commission of all major economic policy changes and trends. The same procedure applies to the current EU members. Cooperation continued also in the field of economic forecasts.

[2] Acquis communautaire.

CRITERIA FOR JOINING THE EUROPEAN UNION AND ECONOMIC AND MONETARY UNION

EU Membership Criteria

At the Copenhagen summit in June 1993 the European Union set the following membership criteria:

- *the candidate country must achieve stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities;*
- *the existence of a functioning market economy, as well as the capacity to cope with competitive pressure and market forces within the Union;*
- *the ability to take on obligations of membership, that is, adoption of EU legislation and institutional framework, as well as adherence to the aims of political, economic and monetary union.*

The Copenhagen economic criterion supports real convergence in candidate countries or convergence of economic structures and growth of market integration with the EU and reduction of differences in income.

According to the European Commission's assessment in 2002, all candidate countries meet the political criteria and have been able to establish a functioning market economy; provided that reforms continue, candidate countries can cope with competitive pressures within the EU by the time of accession. The ability to take on obligations of membership depends on the adoption of EU legislation and ability to implement it; according to the European Commission's assessment, this process has been successful in candidate countries, but needs completion.

Criteria for Joining the EMU

Upon accession, the new EU members will not become full members of the Economic and Monetary Union (EMU) immediately, but they have committed to join it. The candidates had no right to opt out of the EMU. Among the current members, Great Britain and Denmark have the opportunity to stay out of the single currency area under the Maastricht Treaty.

All new members have set themselves the goal of joining the EMU, although this need not happen at the same time for all. In order to become a full EMU member, the so-called Maastricht criteria or nominal convergence criteria have to be met (in accordance with Article 121 of the Treaty and Protocol 21):

- ***price stability** – inflation must not exceed the average of the three best performing Member States by more than 1.5 percentage points over the past 12 months;*
- ***stability of government financial position** – budget deficit must not exceed 3% of GDP in normal circumstances and the ratio of public debt to GDP must not exceed 60%;*

- ***stability of the exchange rate*** *– over the two-year period of participating in the exchange rate mechanism (ERM2)[3] the exchange rate must not deviate from the normal fluctuation margin, or 15% of the medium exchange rate fixed at the time of joining the ERM; devaluation of the currency is not allowed during this period;*

- ***long-term interest rates*** *– the average nominal long-term interest rate must not be more than 2 percentage points above that of the average of the three best performing Member States in terms of price stability, measured over the preceding 12-month period.*

Besides that, a country wishing to join the EMU has to adopt the relevant legislation in full, which is not obligatory for EMU members with limited rights.

EU Economic and Financial Policy

Recommendations of the Economic Governance Working Group of the European Convention

The Economic Governance Working Group of the Convention analysed the issues of monetary and economic policy and the related institutional questions and submitted its final report on 21 October 2002. The working group recommended that the economic and social objectives of the EU be included in the new Constitutional Treaty. **The working group recommended maintaining the current decision-making system under which economic and fiscal policy lies with the Member States and political coordination takes place on the EU level, but monetary policy within the euro area falls under the competence of the EU – the European System of Central Banks and the European Central Bank.** Members of the working group emphasised, however, that Member States' economic policies are regarded as a matter of common concern and, therefore, there is a need for improved coordination of economic policies.

Coordination of Economic Policies between Member States

The European Union has elaborated an extensive coordination framework for economic, employment and structural policies. The main elements of this framework are Broad Economic Policy Guidelines, complemented by the European Employment Strategy and Internal Market Strategy. The different timing of the annual cycle of different processes as well as additional elements have made the coordination cycle complicated and therefore, in the spring of 2002, the European Council decided in Barcelona that the framework needs to be made simpler and more attention should be devoted to monitoring the implementation of policies.

The new coordination framework focuses on medium-term goals, which creates stability and facilitates monitoring of the implementation of guidelines; weight has been shifted from compiling strategies to their implementation. The new annual cycle of coordination will be used in preparations for the new European Council meeting in the spring of 2003. The policy designing stage began in January with a package of reports assessing implementation; on the basis of the spring meeting of the European Council the Commission will

[3] Exchange rate mechanism ERM – European exchange rate mechanism that links the currencies of the joined countries to the euro with the standard fluctuation band +/-15%.

prepare the guidelines in April. This will be followed by discussions at the European Parliament and the relevant Council meetings and the guidelines will be approved by the European Council in summer. The decisions will be followed by the implementation of policies.

EU economic policy priorities in 2003 and for the coming years are the following:

- raising **employment** to the level agreed by the European Council in Lisbon and Stockholm (to 67% by 2005 and 70% by 2010); promotion of social cohesion: reform of the tax and benefit systems, increase of labour mobility, active employment policy, increase of employment among women and older people, life-long learning, pension system reform, guaranteeing transfer of social security rights (including pensions);

- **furthering entrepreneurship and innovation:** measures to facilitate market entry and exit through reducing administrative burden; increasing EU investments into innovations, human capital and research and development activity (private sector investments are important);

- **integration of European markets:** increasing of competition, reduction of state subsidies, increasing of the degree of adopting internal market directives, liberalisation of energy and transport markets, completing the Financial Services Action Plan;

- **sustainable development:** implementation of the directive on the taxation of energy products, use of environment-friendly technologies and renewable sources of energy.

Coordination of Fiscal Policy

In 2002, several EU members had problems with meeting the budget deficit criteria provided in the Stability and Growth Pact (SGP). The possibility of methodological changes in the SGP budget rules have been discussed for some time already. On 7 March 2003, the Ecofin Council approved the **Report on strengthening the coordination of budgetary policies** that will be submitted for approval to the European Council.

Member States are convinced that no changes are necessary in the Stability and Growth Pact and no new budget rules are needed. **Still, the observance of the nominal deficit will be replaced by the observance of deficit within one economic cycle** – ie achieving budget balance in medium term, while the nominal deficit of any single year must not exceed 3% of GDP. **Countries with large deficits have to reduce the cyclically adjusted deficit by at least 0.5% per year.** Automatic stabilisers have to be allowed to operate symmetrically throughout the economic cycle, that is, in the conditions of strong economic growth the surplus will be saved and in the downward phase of the economic cycle fiscal policy will not be tightened in order to compensate the fall of income due to GDP fluctuations. Attention should also be paid to the sustainability of monetary policy, given the pressures resulting form the aging of the population. **More attention will be paid on public sector debt burden**, first of all in countries with high debt level.

Creation of Single Market of Financial Services

Creation of a single financial and capital market is the cornerstone of the EU internal market. In order to achieve this goal the Financial Services Action Plan (FSAP) was launched in 1999. In Lisbon, the European Council approved the action plan. Realisation of this plan should guarantee complete integration of EU financial markets by the year 2005 and securities markets by 2003. In 2002, the European Council assured in Barcelona that the implementation of the FSAP was still one of the main priorities of economic reforms. The EU financial sector operating under uniform rules enables to expand the markets, favours competition, lowers the cost of settlements and financial services and thus supports economic growth and widens choices available to consumers. Equally important is the protection of consumers and creation of mechanisms for reducing abuse of the single financial market. Advantages of the single market will have a positive effect also on new Member States, facilitating their financial deepening and development of new markets. Clearer rules also reduce financial stability risks.

According to the studies organised by the European Commission, creation of the single market for securities could result in an increase of 1.1 percentage points in EU GDP in the next decade; a single infrastructure for clearing and settlement could reduce the respective costs by half and further integration of retail financial markets might yield potential gains in terms of interest rates of 0.7% of EU GDP[4].

In 2002, good progress was made in the implementation of the FSAP, particularly in the adoption of the following legislative acts:

- Directive on financial collateral arrangements
- Directive on distance marketing of financial services
- Directives on UCITS[5]
- Directive on insurance mediation
- Directive on supervision of financial conglomerates[6]
- Regulation on the application of international accounting standards

Practically all the priorities set at the Barcelona European Council have been achieved or reached the final stage of adoption.

Besides the harmonisation of legislation and rules within the EU, the financial sector legal acts of current and future Member States are also influenced by broader international standards. One of the major recent reforms is the **new capital adequacy accord** (the so-called Basel2), which is being worked out by the Basel Committee on Banking Supervision at the Bank for International Settlements. It will replace the current accord dating from 1988. The main new features concern risks that had previously not been considered and more market-based approach to calculating capital requirements, as well as directing supervision from concrete instructions to assessing the adequacy of risk management in banks. The new accord is scheduled to enter into force in 2006. Consequently, the EU will also work out a new directive on capital adequacy of credit institutions and investment societies.

EUROPEAN CENTRAL BANK

The European Central Bank (ECB) and the European System of Central Banks (ESCB) have an important role in preparing candidate countries for joining the euro area. Although this dialogue is not part of the accession talks, the ESCB follows the approximation process closely, as EU membership will automatically mean an obligation to join the euro area. The ECB is, first of all, interested in the monetary and exchange rate policy aspects of the EU enlargement, functioning of the payment systems and financial stability. In 2002, cooperation between candidate countries and the ECB covered the following fields:

---

[4] European Commission. Financial Services – Meeting the Barcelona Priorities & Looking Ahead. Brussels, 3 December 2002, 7th Report.
[5] Undertakings for collective investment in transferable securities.
[6] Directive on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate.

- **the framework of economic policy analysis of candidate countries**, monetary transmission mechanisms, exchange rate systems and operational joining of the Eurosystem were discussed. Publications were issued on the financial sector and bond markets structure convergence, harmonisation of payment systems, and methods of compiling the balance of payments. The ECB devoted much attention to the use of euro in candidate countries and regular surveys on this issue were launched;

- **economic policy dialogue and creation of technical competence gained momentum.** The main topics of the economic policy dialogue were financial sector and monetary and exchange rate policies from the aspect of real and nominal convergence. Representatives of candidate countries' central banks will participate as observers in the work of the ECB General Council and 13 committees at the ESCB after the signing of the accession treaty. The ECB has begun preparations for the participation of candidate countries in the ERM2 system and their eventual membership of the monetary union. In this connection, discussion is underway on changing the ECB decision-making system after the accession of new members. **On 3 February 2003, the ECB Council approved the recommendation on reforming the voting system of the ECB[7].** On 19 March, it was supported by Ecofin and on 21 March changes in the voting system were approved by the Council composed of EU Heads of State and Government. Among technical preparations, plans for the unified payment system TARGET2[8] should be mentioned.

INTERNATIONAL MONETARY FUND

In 2002, the IMF focused on topics related to ensuring international financial stability and crisis prevention, such as anti-money laundering and combating of financing of terrorism, coordinating relevant standards with other standard-setters in anti-money laundering, sovereign debt restructuring of insolvent countries; IMF's lending policy. The IMF has also improved monitoring of financial markets, expressed through the quarterly Global Financial Stability Report.

In the summer of 2002, the IMF, the World Bank and the Financial Action Task Force on Money Laundering (FATF) approved the common international standard concerning anti-money laundering and combating the financing of terrorism. Reviewing and unification of methodology, that had begun already in the second half of 2001, reached the phase where members of the three organisations approved the implementation of a joint pilot project under the unified international standard in that field. Estonia does not participate in this project as just in November 2003 the regional Select Committee of Experts on the Evaluation of Anti-Money Laundering Measures visited Estonia that deals with money laundering issues in EU candidate countries.

Since 2001, the IMF has been analysing ways to work out the framework for sovereign debt restructuring. In 2002, proposals for statutory as well as contractual approach were prepared. The statutory approach to sovereign debt restructuring contains amendments to the Articles of Agreement of the IMF that have to be approved by all member countries. As different countries have different practices related to bond market legislation, it is difficult to reach consensus. The IMF favours the statutory approach or amendments to the IMF Articles of Agreement and is preparing a thorough report on the functioning of the new mechanism for the 2003 spring meeting of the International Monetary and Financial Committee consisting of representatives from member countries.

---

[7] Recommendation, under Article 10.6 of the Statute of the European System of Central Banks and of the European Central Bank, for a Council Decision on an amendment to Article 10.2 of the Statute of the European System of Central Banks and of the European Central Bank (ECB/2003/1). See www.ecb.int/pub/legal/ecbrec20031en.pdf
[8] Trans-European automated real-time gross settlement express transfer system.

The ability of the IMF to assist member countries in case of balance of payment crises depends mainly on the Fund's own resources and, to some extent, various special credit agreements. The financial resources of the Fund, in turn, depend on the member countries' quotas in the IMF. **The IMF's total quotas are reviewed at least once every five years, in order to guarantee correspondence of the Fund financial resources to the development of the world economy and the potential need for crisis financing.** The last time the quotas were reviewed was in 1998. The 12th general quota review ended in January 2003 with no proposal to increase quotas. The liquidity of the Fund was considered adequate, although changes in it will be kept under special attention in 2003. Estonia's present quota is 65.2 million SDRs or approximately 1.3 billion Estonian kroons.

The IMF and the World Bank continue cooperation in reducing the debt burden of heavily indebted poor countries. The HIPC initiative has continued for five years and although several participating poor countries have managed to reach the so-called completion point where their debt stock would be reduced, the progress has been slower than expected. This can be attributed to internal political factors of these countries as well as external economic shocks (for example, fall of export demand due to the global economic recession and drop in the prices of poor countries' main export articles – agricultural products and raw materials). A similar initiative was launched in the spring of 2002 for the seven poorest and indebted CIS countries – Armenia, Azerbaijan, Georgia, Kyrgyz Republic, Moldova, Tajikistan and Uzbekistan. The debts of those countries consist mostly of sums owed to Russia for raw materials (oil and natural gas) and food.