

BACKGROUND INFORMATION

THE ROLE OF ECONOMIC POLICY MEMORANDA IN ESTONIA'S DEVELOPMENT

Estonia's relations with the International Monetary Fund (IMF) have been close ever since the restoration of independence. Although cooperation with the IMF has been in a variety of forms, the general public is best aware of the memoranda of economic policies (MEPs) the Estonian authorities have signed with the

IMF. The IMF approved the first joint memorandum of the Estonian government and Eesti Pank in the summer of 1992 and a total of eight such documents since then (see Table 1b). The memorandum signed in February 2000 and the November supplement to it remained the last of its kind.

Table 1b. Memoranda of Economic Policies agreed between Estonia and the IMF

Document	Time of Adoption	Period covered
MEP	June 1992	July 1992–June 1993
MEP	June 1993	July 1993–December 1994
MEP	February 1995	January 1995–March 1996
MEP	June 1996	January 1996–June 1997
MEP	November 1997	November 1997–December 1998
Supplementary MEP	June 1998	1998
MEP	February 2000	2000–July 1, 2001
Supplementary MEP	November 2000	until July 1, 2001

The role of MEPs in Estonia's development cannot be overestimated. MEPs have been important economic policy documents that have helped to create domestic consensus in the country. At the same time, the main goal of MEPs has been to increase the transparency and reliability of economic policy.

The 1990s marked the ripening of economic policy ideas in Estonia. This period was characterized by the first full economic cycle, fast economic growth, crises in Asia and Russia followed by adjustments and a new growth phase towards the end of the period.

In view of the past developments and accession talks with the European Union, the economic policy emphasis has shifted more and more towards the European Union in recent years. In this new stage, the MEP-type economic policy documents are

replaced with pre-accession economic programmes submitted to EU bodies.

IN RETROSPECT: Macroeconomic Stabilization in 1992–1994

Due to the specific features of Estonia's economic development, the emphases in the MEPs of the past decade have shifted considerably. While in the first half of the 1990s the main focus was on the stabilization of the economy (curbing inflation, easing the shock stemming from the terms of trade, maintaining employment, stabilization of interest rates, etc) then in the second half of the decade economic policy had to be adjusted to the conditions of restored economic growth.

In the first MEPs the main problem was the continuing decline of the GDP, sharp cuts of the workforce in

the state sector and maintaining the minimum level of various strategic stockpiles. The deficit of the current account was seen as a relatively big threat as due to the worsening of the terms of trade a short-term but rapid increase of the deficit was expected. The support of the IMF, the World Bank and the European Bank for Reconstruction and Development was not excluded in covering the deficit.

Understandably, the first aim of the stabilization policy was to keep consumer prices in check. As we know, the Estonian kroon was introduced in the conditions where year-on-year consumer inflation reached 1000% in the six months prior to the introduction of the national currency. The price dynamics was mostly affected by the liberalization of prices, ie abolition of the state control on prices, cutting subsidies and stopping control over the profit margin of state companies.

The fiscal policy of the early 1990s combined measures aimed at both stabilization and structural changes. The continuing economic recession reduced the current real revenue, although cutting large subsidies provided some relief. At the same time, the entire tax system had to be overhauled: excise taxes introduced, personal and corporate income taxes reformed and taxation of foreign trade regulated. The most important part of the structural policy, however, was privatization, which began from small and medium-sized companies. At the same time, the entire property reform (including restitution) needed a legal framework. All those goals, steps and measures were reflected in the MEPs of that period.

Economic Growth in 1995–1998

As Estonia's GDP began to grow again in 1995, this allowed to declare support of the economic recovery and its sustainability as the main goal of the economic policy. Therefore, equal attention was given in the MEPs to fiscal and financial sector policy.

The phase of economic growth, continuing increase of the current account deficit and gross demand brought regulation of government expenditure to the

focus of attention as a decisive factor in the conditions of a currency board system. The forecasts for the deficit/surplus of the government sector budget were relatively conservative in 1997–1998. The MEPs noted the local government borrowing eagerness, need for capital investments and pressure on social security expenditure as the main fiscal problems. However, the foundation of the stabilization reserve and withdrawal of its resources from internal circulation can be considered among the most remarkable steps until today.

In monetary and financial policy the central bank took the responsibility of curbing borrowing and restructuring the financial sector. The strengthening of the banking supervision body and tightening of the capital requirements of the banks clearly aimed at the long-term stability of the system.

In 1997–1998 the Estonian banking sector acquired the features that it has today – a number of large-scale mergers took place and in the autumn of 1998 major Swedish banks entered the owner circle of Hansapank and Eesti Ühispank (Union Bank of Estonia).

Years of Correction in 1998–2001

The economic recession brought on by the Russian crisis again brought to the agenda such issues as fiscal balance and stability of the financial system. The current account deficit was falling at first, but became topical again about a year ago.

The improvement of the fiscal position aimed at in the last two MEPs (both in 2000) continues to this day. Efficient control over expenditures and improved tax collection have helped Estonia overcome the budget deficit that reached more than 4.5% of the GDP in 1999. This way it is possible to focus tax and structural policies more on steps needed for integration with the EU. As the most important change in the state finance we could mention the abolition of the corporate income tax on reinvested capital, although at first it made dealing with the budget deficit more difficult.

The possible extension of the time horizon of the currency board system until joining the Economic and Monetary Union can be considered an important event in view of European integration. Together with the now already completed reform of the monetary policy operational framework it further strengthens the reliability and efficiency of the Estonian monetary and financial sector. In order to improve the supervision of the financial sector the authorities undertook the task of creating a unified financial supervision body that will be launched on January 1, 2002.

Economic Policy Memoranda Now and in the Near Future

As already mentioned, the MEPs signed in 2000 remained the last of its kind for Estonia. The reasons for this are varied. The most important among them

*is the need for long-term programmes (MEPs covered just one or two years) in the current stage of Estonia's economic development. As a result of European integration, the first **pre-accession economic programme** has been drawn up, which contains goals and forecasts for the **next five years**. There are also several local development programmes in various spheres, which are also aimed at guaranteeing sustainable growth. A number of reforms (administration, health care and pension reform, enhancement of the public sector performance, large-scale privatization, etc), which were already discussed in the MEPs, will be completed under these programmes. Estonia will continue cooperation with the IMF in the form of regulatory procedures, as do all IMF member countries. Let us mention here the Article IV consultations and reports on the transparency of the fiscal, monetary and financial sector, etc, where Estonia has been among the pioneers.*