

LAST YEAR was successful both for Estonian economy and for Eesti Pank. Despite the slowdown of the world economic growth, Estonian economy maintained a rapid development, in the second half of the year inflation inhibited as well. We also managed to uphold the reliability of our monetary policy that, in its turn, relies on Estonia's upcoming accession to the European Union. Both the largest inflow of foreign investments in the last ten years and the general increase of investment activity demonstrate the faith in the continuity of Estonian monetary policy, as well as the upgrading of Estonia's credit rating to a new level remarkable for the EU accession countries. It is a pleasure that, almost for the first time since the restoration of independence, the growth of economy and investments resulted in the increasing number of the employed.

The economic success achieved in 2001 was primarily based on the balanced economic policy reforms of the previous years. Neither internal risks nor relative current account deficit increased and, after a long time, the budget reached a surplus. The stable growth of services' export continued and, although the nominal growth of foreign trade remained moderate, the sectors of industry, which competitiveness on international markets were raised by earlier investments, gave their first fruits.

THE MAIN OBJECTIVE OF EESTI PANK is to maintain the stability and value of Estonian kroon. Eesti Pank has granted extensive rights to carry out that objective, which also involves great responsibility before the inhabitants of the state. The successful economic year allowed us to devote more effort on fulfilling our everyday tasks efficiently and to modernise our activities. Therefore, the introduction to the Annual Report 2001 is somewhat different as well: the emphasis is on the tasks performed by the central bank to guarantee the value of the kroon.

Estonian kroons issued by Eesti Pank and commercial bank's accounts with Eesti Pank have to be backed by foreign exchange reserves at any time. The value of the kroon depends on where and how these foreign reserves are allocated. The aftermath of September 11 terrorist attacks against USA put management principles of Eesti Pank's foreign reserves to the test, in terms of both financial and other operating risks. After passing such a test we can firmly say that the instability in the world economy and financial markets due to the terrorist attack did not endanger Estonian foreign reserves or their liquidity at any moment. At the same time, the year 2001 was more uncertain in the world financial markets than previous years because of the general slowdown of economic growth and the September 11 events, and interest level fell more than expected. Therefore, Eesti Pank reduced its investment portfolio's already low degree of risk even more in November, in order to avoid the possible negative impacts. Income earned from foreign reserves exceeded the forecast by more than one fifth in 2001, primarily due to the fall of short-term interest rates.

The preservation and liquidity of Estonian foreign reserves are one of the cornerstones of the reliability of the kroon. However, the persistence of the kroon depends first and foremost on how well the kroon fulfils the main functions of a currency in the eyes of the inhabitants and companies of Estonia. Attitudes towards the kroon are determined by the possibilities to use the money as a medium of exchange, but even more by expectations for Estonian economy – when economy flourishes, investments are brought in, and new jobs are created, the kroon is also trusted.

THE DIRECT LIABILITY OF EESTI PANK is to maintain the liquidity of the banking system and money market. Two major monetary policy instruments are used to carry out this liability. First, at any moment commercial banks have the opportunity to exchange foreign currency for Estonian kroons and vice versa at Eesti Pank. Second, Estonian commercial banks have to keep certain amount of their assets in liquid freely tradable required reserves.

In recent years the required reserves' system has changed together with developments in Estonian banking and money market. The changes continued in 2001 according to the strategy of monetary policy reform approved by the Board of Eesti Pank in 2000. As of 1 July the commercial banks are allowed to meet up to a half of their reserve requirement by euro denominated highly rated liquid debt securities. The other half of the reserve

requirement is met by deposits kept with Eesti Pank. The liquidity management of Estonian banks is now more in line with the continuous integration of Estonian economy and financial system to the European Union. The expenses of the banking system are also decreasing, indicating that the spread between loan and deposit interest is dropping, as well.

AN IMPORTANT ROLE IN MAINTAINING CREDIBILITY TOWARDS THE KROON plays the confidence in the kroon as a means of payment both in terms of account money settlements and everyday cash payments.

In 2001 Eesti Pank completed a new inter-bank settlement system. The new system, launched on January 21, 2002, allows settling large value payments in real time and smaller retail payments through designated net settlement system. The new settlement system is in compliance with best international standards and essentially reduces the risks.

The quality of Estonian banknotes has been high throughout the time since the restoration of independence. To retain the security of our currency, Eesti Pank continued to work out banknotes of the new generation. In addition to new 100kroon banknotes issued in 1999 and new 500kroon notes issued in 2000, Eesti Pank prepared the specification of a new 25kroon note to be issued in June 2002.

In relation to meeting the cash demand of the public, it is also worth mentioning the active involvement of Eesti Pank in the introduction of the euro notes and coins in 12 Member States of the EU as of 1 January 2002. Eesti Pank made sure that commercial banks were provided with euro cash on the very first workdays of 2002. The central bank played an important role also in acquainting the public with the new money and in training the bank's personnel for operations with the euro.

FINANCIAL MARKET INFRASTRUCTURE AS WELL AS BANKNOTES AND COINS OF HIGH QUALITY are important preconditions for preserving the value of the kroon. However, merely technical preparedness is not enough. Confidence in the kroon is maintained through the confidence in Estonian economy. Constant analysis of the economy and its operational environment is the most important field of activity for Eesti Pank. It is the analysis that our readiness for concrete, urgent if necessary, monetary and financial policy decision-making is based on. The quality of the central bank's economic analysis and efficient decision-making mechanism are the main guarantees of the credibility of Estonian kroon now and in the coming years.

In 2001 the arrangement of economic analysis changed considerably in Eesti Pank. The Bank's decisions are now based on regular monthly and quarterly economic policy surveys, including assessment of Estonia's economic situation and the comparison with forecasts, as well as monetary and financial policy conclusions. The documentation for the analysis is prepared by an inter-department workgroup and is presented to the Monetary Policy Committee for taking up a position. The analyses rely on thorough and precise monetary, banking and balance of payments statistics. Summary of the assessment is published once in a quarter as a press release immediately after the meeting of the Monetary Policy Committee. A thorough economic analysis is presented to the public regularly in the monetary policy survey published four times a year.

In spring and autumn 2001 Eesti Pank compiled and published a regular forecast of the main indicators of Estonian economy. In the autumn forecast compiled immediately after the September 11 events in the United States, we foresaw two possible development scenarios for the years 2002 and 2003 – besides the main development plan also a risk scenario based on considerably lower economic growth. Fortunately, the latter did not come true.

RETAINING THE RELIABILITY OF THE FINANCIAL SYSTEM is an inseparable part of preserving the value of the currency. Commercial banks intermediate the money of those who save to loan debtors providing, thus, the financing of new investments and consumption to a large extent. Only a strong banking and financial system observing modern rules of market economy and implementing efficient supervision is able to fully meet this criterion.

In 2001 the most important change in the organisation of financial system policy was the launch of Financial Supervision Authority by Eesti Pank. This way banking and financial policy was institutionally separated from immediate supervision. The formation of banking and financial policy, as well as the issue of legislation now lies within the jurisdiction of Eesti Pank and the Ministry of Finance and Financial Supervision Authority implements immediate control over banks and other financial institutions under state supervision.

Consolidating supervisory functions into a unified structure gives Eesti Pank an opportunity to direct more resources to the formation of banking policy in the period prior to the EU accession. This is especially important considering the rapid development of banking and financial market legislation in the EU during the last two years. The amendments to the Estonian Credit Institutions Act in 2001 harmonised our banking legislation with the European Union acquis, enabling to monitor and regulate the risks taken by banks. Now we can say that the legal acts regulating Estonian banking are in full compliance with those of the European Union, except for a few norms that are stricter in Estonia.

IMPLEMENTATION OF CURRENCY BOARD ARRANGEMENT and the pegging of the kroon with the euro is not a purpose in itself, rather it is a means of achieving low inflation level and through this supporting the development of Estonian economy. I am certain that for Estonia, like for other developed European countries, the most efficient way for achieving price stability and rapid economic growth in the coming years is joining the European Union, the European System of Central Banks and the euro area.

As far as Eesti Pank is concerned, the monetary and financial policy integration to the European Union can be divided into two important stages. After the accession to the European Union the exchange rate of Estonian kroon against the euro will be fixed in the agreement between the European Union and Estonia. This way Estonia will join ERM2 – the exchange rate mechanism of the euro and the currencies of EMU members with a derogation. EU has confirmed that Estonia's current policy based on the fixed exchange rate is in compliance with ERM2 requirements. Therefore, neither the exchange rate between Estonian kroon and euro nor the currency board system will change after the accession to the European Union.

A new member has to participate in the exchange rate mechanism ERM2 for at least two years. If our economy meets the required criteria for introducing the euro (so-called Maastricht criteria) by the end of this period, Estonia becomes a full member of the European Economic and Monetary Union, the euro will be introduced and Eesti Pank will participate in the work of European Central Bank's decision-making bodies as a full and equal member.

JOINING THE EUROPEAN SYSTEM OF CENTRAL BANKS is a serious challenge for Eesti Pank in many respects. After three years we have to be ready to participate in implementing common monetary policy in Europe, which requires the use of monetary policy instruments that are new for Estonia, as well as gathering more thorough statistics than ever before. We have to be prepared for taking part in the work of European Central Bank's decision-making bodies and committees as a full and equal member, which sets completely new demands to our analyses and decision-making mechanism. At the same time, we have to fulfil our current tasks just as efficiently – to ensure the operation of Estonia's payment systems, to form banking policy being a part of the common market and meet the cash – this time the euro – demand of the public.

All this requires constant self-development from the Bank's personnel and even more efficient and planned action than before. Eesti Pank has conducted an organisational reform and restructured Bank's management. Therefore, we can confirm that the central bank meets all constitutional requirements efficiently. An additional impulse for action has been accomplished through the synergy from uniting Bank's departments and the established Monetary Policy Committee has made the decision-making faster, more harmonious and of higher-quality.

At the time this Annual Report reaches its readers, all Estonia celebrates the 10th anniversary of the monetary reform and the re-introduction of the kroon that laid the foundations for economic success of our independent country. Let this remarkable date in our history be not only the opportunity for all of us to take pleasure in what is done, but let it also add strength and energy to face the important challenges of the future.

Vahur Kraft
Governor of Eesti Pank

