DOCUMENT OF THE EUROPEAN BANK
FOR RECONSTRUCTION AND DEVELOPMENT

STRATEGY FOR ESTONIA

As approved by the Board of Directors at its meeting on 8 September 2009

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EXECUTIVE SUMMARY

Estonia continues to meet the conditions specified in Article 1 of the Agreement Establishing the Bank. Estonia has made substantial progress in transition since independence and is now one of the most advanced countries in the region. Some 80 per cent of economic activity is in the private sector, and price and trade liberalisation, enterprise restructuring and effective financial sector reforms have taken place. There is an open foreign trade regime and there are no major constraints on foreign investment.

Since the last country strategy was approved the Estonian economy has entered the most challenging economic period since independence. With macroeconomic imbalances becoming increasingly evident in 2006 and 2007, leading to a weakening in competitiveness and rising inflation, commercial banks started to be more restrictive with lending. This in turn led to decelerating asset prices and economic growth. Sectors that previously were leading growth, such as real estate, construction and financial intermediation are now in a severe recession. Moreover, the deepening global financial crisis in 2008 and the rapid slowdown in external demand have further weakened growth prospects in Estonia. Given the high accumulated private external debt, Estonia also remains exposed to external vulnerability. However, fiscal reserves built in previous years will meet immediate financing needs. The banking system remains sound, but is facing significant challenges as credit losses are rising steeply. As banks are predominantly foreign-owned, the sector benefits from being able to draw on supportive stabilisation programmes in the home countries. Other strengths include a sound legal framework and government institutions, a flexible labour market and favourable business environment, and EU membership which gives access to significant EU structural funds.

In the current environment the main objective of the government will be to secure macroeconomic and financial stability and to continue to implement the remaining elements of the structural reform agenda. Investor confidence will be crucially influenced by the speed of adjustment of external and domestic imbalances as well as the ability to improve price competitiveness and to control the deterioration in public finances. In the medium-term, re-focusing the economy towards the tradable sectors and developing key sectors for future growth will be equally important. Against this background, the key transition challenges for Estonia include:

- **Reinforcing the stability of the financial system**, while ensuring the sector's contribution to economic restructuring. The smooth functioning of the financial sector in providing capital is crucial for the economy, which requires further efforts to maintain and develop financial intermediation, especially for SMEs through equity and mezzanine capital, while strengthening banks' capital bases, supporting the restructuring of debt and improving the take-up of EU structural funds.
- Promoting sufficient **alternative energy supply, energy efficiency and renewable energy** in order to enhance sustainability, reduce energy intensity and meet environmental targets. This requires major decisions as regards restructuring of oil-shale based power plants and the development of new power links to regional energy markets.
- **Modernising municipal and environmental infrastructure** with the assistance of EU structural and cohesion funds, private sector involvement and commercial co-financing from local sources where possible.

- **Improving long-term competitiveness**. Further reforms in the areas of education, innovation, competition policy and infrastructure reform will be necessary to ensure competitive advantages that will attract foreign investment.

Since the last country strategy was approved, the Bank's activities in Estonia have remained very limited as a result of significant progress in transition and reflecting the further development of a very competitive banking sector dominated by Nordic banks. The Bank has signed four projects for an amount of EUR 12 million in 2006 – 2008.

Until a new medium term strategy is adopted by the Board of Governors, the Bank's operational objectives in Estonia will remain in accordance with the strategic outline for the years 2006 – 2010 agreed upon in Capital Resources Review 3, while also addressing the crisis needs in Estonia and across the region, without questioning graduation. Specific anti-crisis measures will be consistent with the crisis response programme adopted by the Board of Directors.

The Bank will work closely with the commercial banks and other IFIs to mobilise financing for nationally important projects in infrastructure and energy sectors as well as facilitate lending to SMEs and financing of energy efficiency projects. The Bank will also look for other opportunities to address the enhanced needs in Estonia due to the ongoing financial crisis.

In light of the crisis and the deterioration of the external environment outlined above, the Bank's activities in Estonia will be based on the following operational objectives:

- Foster commercial banks' continued lending to the corporate sector, particularly to SMEs, by providing long term capital to financial institutions, by risk sharing in their portfolios and invest in mezzanine and equity funds to ensure availability of financing.
- Facilitate investments in the diversification of energy supply, in energy efficiency and renewable energy.
- Support municipalities, where appropriate, through public-private partnerships and through financial institutions to ensure commercial co-financing for EU funded projects.
- Provide higher-risk products such as equity for local corporations to fund their growth and improvements in competitiveness.
- Proactive review and management of the Bank's portfolio to improve its quality.

The Bank will continue to ensure that all EBRD operations in Estonia meet sound banking principles, have transition impact, are additional and are subject to the Bank's Environmental and Social Policy and incorporate, where appropriate, Environmental and Social Action Plans.

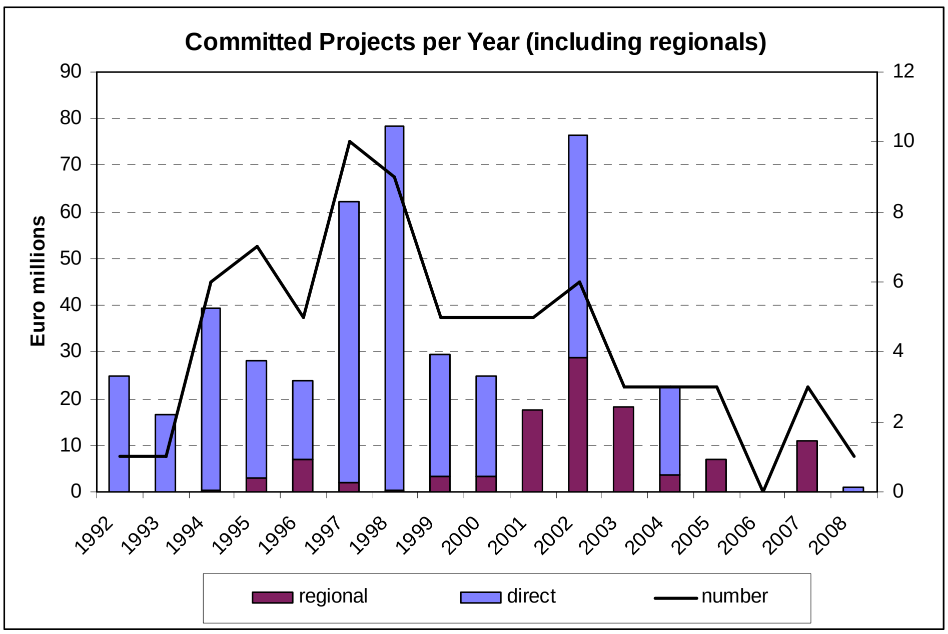
1. THE BANK'S PORTFOLIO

1.1 Overview of activities to date

The Bank has been supporting Estonia's successful transition to a market economy by financing mostly private sector projects in various economic sectors, but with an emphasis on the financial sector. Up to March 2009, the EBRD has committed a total of EUR 481 million or 1 per cent of Bank-wide commitments. Forty-nine per cent of the cumulative business volume relates to FI reflecting the Bank's significant role in the sector. The Bank's role in infrastructure and corporate sector has been important with 29 per cent and 17 per cent of total commitments respectively. In the energy sector EBRD's role has remained marginal with only 6 per cent of total commitments.

Chart 1 below illustrates the activity of the EBRD in terms of the number of projects and amounts committed by EBRD in Estonia since 1992. The Bank's activity started early concentrating in direct projects with the biggest volumes between 1997 and 2002. Since 2002 the number of projects has decreased markedly with most investments being of regional nature. This reflects Estonia's progress in transition and the strong presence of commercial banks in Estonia.

Chart 1 (as of 31 March 2009)



The current portfolio is EUR 90 million or 0.4 per cent of total Bank portfolio. It has stayed virtually at the same level as at the end of 2005 when it was EUR 91 million. The portfolio is 100 per cent private and 44 per cent is equity. The impaired asset represent 21 per cent of the portfolio consisting of one general industry project rated at 9 bringing the portfolio risk rating down to 6.76. A substantial portion of the current portfolio (38 per cent) relates to MEI consisting of one investment in the sector. Equity Funds represent also 38 per cent of the portfolio, a reflection of EBRD's strong support to SMEs as an investor in regional equity funds. General Industry's share in the portfolio is 21 per cent, consisting of the above mentioned project rated at 9.

1.2 Implementation of the previous country strategy

The Bank's country strategy for Estonia, approved in June 2006, set four main strategic priorities:

- Support the development of renewable energy projects;
- Support the expansion of local companies, particularly in cross-border projects by providing long term risk capital (equity, structured debt);
- Promote SME and municipal financing and energy efficiency through financial intermediaries as well as directly with a broader selection of financial instruments, enhanced with EU, or other, donor support; and
- Support complex transactions across sectors, including public private partnerships, which would benefit from the Bank's expertise in project structuring and mobilisation of co-financing.

During 2006 to 2008 the Bank signed four investments, of which only one was direct, an investment in a wind farm project. Overall, the Bank partially achieved the operational objectives set out in the previous Country Strategy. The Bank supported the development of renewable energy and by investing in a regional equity fund targeting energy efficiency and renewable energy investments. During the strategy period the Bank also invested in two equity funds investing in SMEs. The Bank has been working on building a pipeline of projects, including energy efficiency and renewable energy and in manufacturing, agriculture and services related industries.

1.3 Transition Impact of the Bank's Portfolio and Lessons Learned

1.3.1 The Financial Sector

Banking – Since 1996, EBRD has played a central role in the transition of the Estonian Banking sector with its lending to local banks, such as Hanspank and Eesti Uhispank. Improvements were fostered in the area of corporate governance and standards for preventing fraudulent behaviour have been introduced. The Bank initiated the development of the mortgage market for private individuals and contributed to consolidation in the Banking sector through projects to facilitate mergers and take-overs. A ***lesson learned*** from the project with Eesti Uhispank is that by continuing to work with existing clients during periods of economic uncertainty, the Bank can preserve and even increase transition impact (PE03-247).

NBFI – The Bank's provision of a regional credit line to Hansa Capital was successful in providing asset-backed finance to SMEs that would otherwise have remained credit constrained. In 2002 the Bank supported pension reforms and stimulated the local securities market through its equity stake in LHV Asset Management, a private pension fund management company. Following the merger of LHV with Seesam Asset Management, another Estonian pension fund, the Bank participated in a capital increase in 2006. A ***lesson learned*** from the equity investment in LHV is that a successful pension reform launch requires a governmental publicity campaign in order to inform the population on the benefits of the reforms (PEX04-220).

SME & MSME – The Bank has participated in the setting up of a number of regional investment funds and the provision of SME credit lines to Hansapank, Eesti Uhispank and Sampo Pank. Being coupled with a large TC project, there have been good results achieved overall in providing access to the Banks financing to SMEs. Further activities should focus on the usage of new financial instruments, such as equity and mezzanine capital.

Private Equity - Since the late 1990s a number of regional pan-Baltic private equity funds invested in Estonian enterprises covering a wide variety of sectors, including construction, furniture, brewing, meat processing, manufacturing, media, IT and biotech. The early Baltic Funds have seen a number of very attractive returns on some of these investments, which has triggered a renewed interest by private investors from Scandinavian countries.

Overall, Transition Impact within the *Financial* Sector is rated as *Significant.*

1.3.2 The Enterprise Sector

Agribusiness **-** The 2000 investment in the Baltic Food Holding helped with an expansion of wholesale operations but eventually the company went bankrupt. Through its investment in Kesko, the Bank achieved some moderate transition impact, in terms of market expansion through linkages to local suppliers and distributors and increased competition in food retailing and wholesaling.

General Industry – The Bank has achieved mixed results in its early activities with Baltex, and the same appears to be true with its 2004 investment in 'Estonian Cell'. Good achievements i.e. improved production efficiency and more sustainable forest management have been seen on one hand, however, the company was at the same time suffering from severe financial difficulties.

Telecommunications - The Bank has not undertaken projects, but has played an important role in helping to strengthen the regulatory framework. Partly due to this assistance, a new law was passed in Spring 2000 laying the groundwork for regulation of the fixed line market.

Overall, Transition Impact within the *Enterprise* Sector is rated as *Minimal to Moderate*.

1.3.3 Infrastructure

Energy Efficiency and Power – The Bank has had no direct involvement with typical energy efficiency projects. The early energy sector emergency investment project (1993 – 1997) however, assisted with urgent repairs to power supply and DH facilities. Together with the promotion of tariff reform, and competition through open tendering in the sector, it has contributed to raise general awareness on energy efficiency and energy conservation.

MEI – The Bank's involvement with Tallinna Vesi – the municipal Water Company - has moved along all stages of reform: sovereign guaranteed loan to the municipality, corporate loan, privatisation to a strategic investor in 2001 and recently the successful IPO. Twinning with Helsinki Water helped introducing MIS systems and IAS-based accounts and had significant demonstration effects. A ***lesson learned*** from the Bank's engagement with Tallinna Vesi points to the importance of taking a strategic long-term view. Through its early involvement with the Tallinn Municipality, the Bank was able to address technical, legal and regulatory concerns over time, so as to ensure a successful privatisation launch (PE04-288).

Transport – The Bank was early involved in the airport sub-sector, introducing more effective and commercial management procedures, but seeing the transition impact potential diminishing later on. The EBRD loan to Estonian railways was successful initially, by triggering the restructuring process and preparing a privatisation model. However, transition was reversed when the Government bought the majority of shares back in 2007, thus, de facto re-nationalising the Company. A ***lesson learned*** from the Tallinn Airport Passenger Terminal Reconstruction project is, that the extension of the Engineering Consultant's contract to include a brief inspection of the facilities prior to the major warranty periods expiring, was very beneficial for the Client and the Bank (PE01-182).

Overall, Transition Impact within the *Infrastructure* Sector is rated as *Moderate*.

2. OPERATIONAL ENVIRONMENT

2.1 General Reform Environment

Since independence, Estonia has made significant progress in the transition to a modern market economy. The structural reforms initiated in the 1990s have been successful and their implementation far-reaching. The reform agenda in recent years focused on the adoption of the EU *acquis communautaire* and entry to the EU in May 2004. As a result, Estonia is now one of the world's most open and competitive economies according to various surveys of the business environment. The transition indicator scores published in the 2008 *Transition Report* indicate that Estonia is among the most advanced in transition in the new EU member states in each of the nine categories measured. In three categories – price liberalisation, trade and foreign exchange liberalisation and small-scale privatisation – Estonia has already achieved standards of a well-functioning market economy. The potential for significant reform reversals is limited, despite the drastic reduction in output growth, as the benefits of market-based democracy is shared among the political elite and the polity.

Estonia enjoys a highly attractive business environment. Both petty and high-level corruption remain low, and Estonia has steadily risen up the global rankings on Transparency International's Corruption Perceptions Index, to be ranked 27th out of 180 countries globally in 2008. Business regulation also remains competitive. Estonia is ranked 22nd globally in the World Bank's Doing Business 2009 survey for the ease of doing business, and remains the highest ranked country in the CEB region. Estonia, however, scores below the CEB average in terms of employing workers, access to credit, enforcing contracts and closing a business.

While Estonia's business environment remains attractive, rapid growth in recent years has led to imbalances which have affected competitiveness and external sustainability. The costs and regulatory burden surrounding hiring and firing, as well as rigidity of employment, continue to be significantly higher than both the CEB and OECD averages. Although labour shortages have abated as the impact of the economic crisis has spread to the labour market, they are likely to resurface as a major challenge in the longer run owing to the projected decline in population. Against this background, in July 2008 the government drew up plans for developing competitiveness and expanding export capacity, with a focus on improving the business environment, education, labour markets and co-operation between enterprises and the scientific establishment. The government adopted a new labour law in December 2008 which aims to increase flexibility by reducing some of the rigidities in hiring and firing workers, while improving the unemployment safety net, although the rise in unemployment and the need for fiscal austerity resulting from Estonia's deepening economic crisis in the first half of 2009 has led the authorities to propose limitations on some of the unemployment benefits entailed in the law.

2.2 Political developments

Since independence Estonia's political system has been characterised by often unstable and short-lived multiparty coalition governments. The political system has nevertheless functioned effectively, based on the widespread elite and electoral consensus on the reforms necessary to ensure Estonia's 'return to Europe' in the form of NATO and EU memberships. Since those objectives were achieved in 2004, however, the weakness of Estonia's coalition governments has become more of a stumbling block, given the complexity of the remaining 'third phase' transition and structural reform challenges the government faces, and particularly since the onset of the economic crisis in 2008.

A three-party coalition government – comprising the liberal Reform Party led by the Prime Minister, Andrus Ansip, the centre-left Social Democratic Party (SDP) and the conservative-nationalist Pro Patria-Res Publica union (IRL) – came to power following the March 2007 parliamentary election, in which Ansip's Reform Party received a plurality of 31 of the 101 seats in the Estonian parliament, the Riigikogu. With the SDP's 10 seats and the IRL's 19 seats, the Ansip government enjoyed a comfortable majority of 60 seats. While the coalition survived until May 2009, minor ideological differences and permanent electoral jockeying among the three ruling parties stalled progress on the reform front. The governing coalition was reduced to a minority of 50 seats in late-May 2009, when the Social Democrats withdrew from the coalition over disagreements about the proposed spending cuts necessary for Estonia to meet the Maastricht criterion on the budget deficit.

2.3 Macroeconomic conditions relevant for the Bank's operations

Economic growth in Estonia slowed rapidly in 2008, resulting in a contraction of -3.6 per cent compared with growth of 7.2 per cent in 2007. In the first half of 2009, the annual decline in real GDP amounted to 15.6 per cent. Estonia, along with the other Baltic countries, belongs to the group of countries that have been among the most affected by the global financial crisis. With growing concerns over asset prices, high import growth and capacity constraints, domestic demand started to decelerate from its peaks in 2006 as banks starting to be more restrictive with lending. Following years of above potential economic growth (annual growth averaged 8.4 per cent between 2000 and 2007) a number of vulnerabilities had became apparent: an excessive current account deficit leading to a very high private external debt (114 per cent of GDP in 2008), high inflation and concentration of growth to the domestic sector, especially real estate, construction and financial intermediation. The global financial crises brought further challenges as it deepened in the autumn of 2008 and led to further credit restraints and reduced external demand, especially from neighbouring countries.

CPI inflation peaked at above 11 per cent in mid-2008, as rising food and energy prices added to cost pressures on prices, and averaged 10.4 per cent for the year as a whole. Annual inflation started to decelerate rapidly in the autumn of 2008, and decelerated to -0.7 per cent in July 2009. Inflation is expected to remain negative in 2009 and into 2010, making it increasingly possible that the Maastricht reference value for inflation will be achieved. The rise in inflation since 2004 forced authorities to postpone the target date for euro adoption from the initially planned date of January 2007. Wage growth has slowed down significantly from over 20 per cent in mid-2007 to

-1.5 per cent in the first quarter of 2009 and is expected to decline by as much as 15 per cent in 2009 as slack in the labour market deepens. The unemployment rate rose to 13.3 per cent in June 2009 having been as low as 3.8 per cent in April 2008, reflecting the rapid deterioration in growth.

Estonia has a strong record of fiscal soundness and the budget remained in surplus between 2001 and 2007, while government debt has remained the lowest in EU at around 5 per cent of GDP. In 2008, however, a budget deficit of 3 per cent of GDP was recorded as weaker growth affected budget revenues. The government introduced emergency spending cuts in 2008 to halt the increase in the deficit and has made additional significant expenditure adjustments to the budget in order not to breach the 3 per cent of GDP Maastricht criterion for euro adoption. While the budgetary situation does not present near-term financing risks given the prudent accumulation of fiscal reserves via surpluses in previous years, further consolidation measures are needed in order to comply with the criteria for euro area entry.

Following the widening of Estonia's current account deficit to 17.8 per cent of GDP in 2007, the deficit narrowed to 9.5 per cent in 2008 as imports fell rapidly. In the second quarter of 2009, the current account moved into a surplus of 4.9 per cent of GDP and it is expected to show a small surplus for the year as a whole. Net FDI inflows declined somewhat in 2008 and covered around half of the current account deficit. With foreign banks having provided most of the financing for the rapid growth in credit, external debt has increased drastically since 2005 and stood at 114 per cent of GDP in 2008, down around 5 percentage points from 2007. Practically all of this external debt was held by the private sector. Net external debt, however, taking into account assets held in foreign currency, amounts to only around 30 per cent of external debt.

In the financial sector, a rapid deterioration in credit quality is underway, forcing a number of the main Nordic parent banks to raise new capital. The presence of foreign banks remains a positive factor, also given that subsidiary banks can draw on financial sector stabilisation programmes in the home countries, and all major parent banks have confirmed their commitment to staying in the region. Overall, the banking system remains sound, and foreign ownership has over the years led to the necessary restructuring and recapitalisation of the system, the introduction of a wider array of products and services and improved corporate governance and transparency.

The economic outlook remains highly challenging, with the global financial crisis leading to a significant tightening in financing conditions. Combined with the contraction in external demand, in particular in neighbouring countries with which trade relations have become increasingly important, the economy is expected to contract further in 2009 and only stage a moderate recovery thereafter. This will put severe pressure on public finances and general living standards in the medium-term. Estonia has not drawn on any IMF led financial package, although lending is expected to increase from other IFIs while also aiming to make use of available EU structural funds, partly since fiscal reserves built in previous years have provided a buffer for rising budget deficits and short-term external financing needs. While there is a need for policy measures addressing the immediate risks to macroeconomic and financial stability, efforts to safeguard long-term competitiveness and external sustainability will be equally important. These include continued work for sustainable solutions in the area of energy, education and innovation, as well as shifting production towards more export oriented sectors.

2.4 Transition Successes and Challenges

The following sector-by-sector analysis of remaining transition challenges highlights several priority areas.

Energy and Infrastructure sectors

Energy: *energy supply and energy efficiency are important priorities.*
The issues of securing sustainable energy and the development of renewable energy are becoming increasingly pressing in Estonia in light of the high reliance of fossil fuels, the high energy intensity and the closure of Ignalina nuclear power plant in Lithuania at the end of 2009. In November 2007 Eesti Energia acquired the Aulepa wind park development with the aim of building the largest wind park in the Baltic states. The park will start operating in 2009 and will supply 1.3 per cent of Estonia's electricity consumption. The move is part of Eesti Energia's long-term strategy of decreasing carbon dioxide emissions and a response to the need for more generation capacity by 2016 when the oil-shale-fired power plants of AS Narva Elektrijaamad, which have not been brought into compliance with the EU directive on large combustion plants, will be closed or reconstructed. Restructuring the existing oil-shale-based power plants remains a significant challenge, not least from an environmental perspective. In addition, Eesti Energia has initiated negotiations with Latvia, Lithuania and Poland on the construction of a new nuclear power plant in Lithuania. As these plans are still uncertain, the Estonian and Finnish authorities have also held discussions over the possibility of building a nuclear power plant in Estonia while a second underwater cable between the two countries has been agreed.

The process of the unbundling of Eesti Energia started in April and July 2004 when Eesti Energia set up separate subsidiaries for the transmission network (OÜ Põhivõrk) and the distribution network (OÜ Jaotusvõrk) based on its existing business units. Although several options have been discussed since then, privatisation has been ruled out. The electricity market for companies that consume over 40 GWh has been open since 2003. Further liberalisation is expected by end-2009 when 35 per cent of the market will be opened with a view of full opening by 2013. Private sector participation in generation and distribution is significant but effective competition is limited by the small size of the market. The quality of institutions has been further strengthened. In 2007 the regulatory framework for renewables was significantly strengthened with the introduction of a feed-in tariff and mandatory off-take mechanism. A fully independent regulatory authority for the power sector is in place, electricity tariffs are cost-reflective, and cross subsidies have been eliminated. Estonia has the highest energy intensity in the CEB region, although energy tariffs have been increased and the country has ratified the Kyoto protocol.

Railways: operating and policy setting functions have been separated. Operating companies have been privatised in vertically integrated feature in 2001. An independent regulator was established and infrastructure access is granted on a non-discriminatory basis. However, in January 2007 the government reversed the controversial 2001 privatisation of Estonian Railways (the freight operator and owner/manager of the rail infrastructure – by buying it back from Baltic Rail Services (BRS), an international consortium owned by three strategic railway investors and a local company. The State agreed to pay Kr 2.35 billion (USD 188 million) to the consortium for its 66 per cent stake (which had originally cost BRS Kr 1 billion). Relations between the government and BRS had soured following the election in 2003 of a new government opposed to the privatisation and the introduction of a new Railways Act. Differences in interpreting the original privatisation contract and changes to corporate governance in the light of the new Act had resulted in numerous legal actions on both sides. Railway labour productivity is one of the highest in the transition region.

Roads: The Road Law and the Road Act were enacted in 1991 and 1999 respectively. The national road administration is only semi-independent. Road maintenance was partly divested but the process remains incomplete. Road user charges are sufficiently high enough to cover the maintenance/rehabilitation costs. There have been no PPP projects in the road sector.

Municipal services and infrastructure: *there is scope for private involvement in the delivery of public services and in EU financed infrastructure projects.*
In the larger municipalities, both water heating and transport companies tend to be well run and financially solid. However, inadequate water and sewage systems still operate outside the large cities that are not meeting adequate standards. Estonia has successfully privatised Tallinn Water and introduced substantial private sector participation in district heating and urban bus services. Despite investment and operational needs, there is limited private sector participation in municipal sectors including water and sewage, urban transport and in the development of state transport infrastructure. With substantial fiscal pressures on municipal finances there is an increasing scope for private involvement in increasing efficiency in the delivery of public services.

Financial sector

Banking sector: *The financial sector is well-developed, but fast credit growth in recent years and the current financing constraints have exposed the sector to heightened risks.*
The basic regulatory framework in the Estonian banking sector is in place and the sector is fully privatised. The number of banks has increased in recent years and the vast majority is foreign-owned (99 per cent of assets in 2007). Fast credit growth in recent years has exposed the sector to heightened risks, although current financing constraints is leading to rapid slowdown in credit growth. A combination of low nominal, and negative real interest rates and a highly competitive banking sector environment contributed to an annual growth of domestic credit to the private sector of over 50 per cent between mid-2005 and mid-2007, raising the share of domestic credit to the private sector to close to 90 per cent of GDP in 2007. Since early 2007, credit growth to the private sector has however slowed down significantly and grew by a mere 2.3 per cent in April 2009.

The banking sector is facing more challenging times as conditions on the international financial markets deteriorate. Until recently when growth was high, the banking sector remained highly profitable with a negligible ratio of non-performing loans. With the weakening domestic economy, particularly in the housing and construction sectors, asset quality is deteriorating and past due payments and credit losses have increased. While the credit growth has slowed down to more sustainable levels, there is a risk that financing will be excessively restrained which would further worsen the macroeconomic situation. With credit quality deteriorating rapidly, Swedish parent banks (representing some 75 per cent of lending) have been raising new capital to absorb expected credit losses. Efficient home-host country supervisory coordination has implied early identification of capital needs and rapid measures to support the banking system. Government support measures in home countries, including temporary guarantees for medium-term loans and funding for recapitalisation, have not carried any restrictions in access to capital for foreign subsidiaries. Risks will increase further if there is a more pronounced and lasting economic slowdown in the region. In Estonia, over 80 per cent of all loans are in foreign currency.

Enterprise sector

General industry: *policy measures are needed to improve skill levels in the labour force, innovation and increase long-term competitiveness.*
Although the investment climate in Estonia remains highly competitive, rising wage levels have put renewed pressure on price competitiveness. Business regulation remains highly competitive with Estonia remaining the highest ranked country in CEB in the World Bank's Doing Business 2009 survey for the ease of doing business. Measures to secure long-term competitiveness relate to rigidities in hiring and firing workers, raising skill levels and promote innovation. Although labour shortages are expected to abate for cyclical reasons, they are likely to remain a challenge in the longer run owing to the projected decline in population.

SMEs: *providing SMEs with sufficient finance will be a challenge*
As the economy slows, financing conditions have become increasingly constrained. Additional measures may be necessary in order to support SMEs with alternative financing sources, while further steps for improving the use of available EU funds may also be required. Measures that are being implemented include providing additional export credit guarantees and financial support for hiring foreign specialists.

2.5 Legal Environment

Since Estonia joined the European Union on 1 May 2004, it has continued to adapt its legal framework in order to bring it in line with the standards and legislation of the European Union.

Some measures aiming at further combating business or financial criminal activities have become effective. Hence, a new Money Laundering and Terrorist Financing Prevention Act transposed EU law into Estonian law and the Financial Supervision Authority issued some advisory guidelines containing additional measures in this respect.

Corporate, commercial and financial activities are regulated by Estonian laws which, in general terms, have regularly transposed EU Directives. The previous EBRD country strategy had identified some areas such as corporate governance, secured transactions and corporate reorganisation where legislation was not in line with international standards. These issues have been partly tackled with the adoption of the Corporate Governance Code in January 2006 and of new legislation in 2007 and 2008 (e.g. the new Reorganisation Act in December 2008). Estonia's court system is considered to be performing independently. There is still however a need for improvements in the scope and application of secured transactions legislation.

2.6 Environmental Issues

Estonia has implemented EU *acquis* in all areas to date except in areas where transitional periods were agreed, including:

- urban waste water treatment (until 2010)
- the quality of water intended for human consumption (until 2013)
- landfill of waste (until 2009)

Estonia's sustainable development goals and priorities are based on implementing EU Sustainable Development Strategy as well as the Estonian National Sustainable Development Strategy "Sustainable Estonia 21".

3. STRATEGIC ORIENTATIONS

This strategy will remain in accordance with the strategic outline for the years 2006 – 2010 agreed upon in Capital Resources Review 3, while also addressing the crisis needs in Estonia and across the region, without questioning graduation.

3.1 Bank's Priorities for Strategy Period

In the current environment of a contracting economy and reduced lending by commercial banks, EBRD support for the financial sector and viable, nationally important projects especially in the energy sector is important in order to maintain already achieved levels of transition. This will be reflected in the Bank's operational priorities.

In an attempt to respond to the worsening external environment in a manner consistent with the analysis of Estonia's remaining transition challenges, the Bank's immediate focus will be to respond to the exceptional economic circumstances by focusing on the following critical areas:

- **Ensure the continued availability of credit to SMEs and the corporate sector.** This is best achieved through the provision of credit lines and capital to local banks in close co-operation with other IFIs.

- **Consider investments in close collaboration with other IFIs to improve energy efficiency and support selected new generation projects, particularly from renewable energy sources to contribute to energy security.** This will improve competitiveness by reducing the high energy intensity of the Estonian economy and contribute to improving energy security.

- **In light of the decrease in available debt financing, support local companies, most of which are SMEs, with equity capital.** This could be achieved through investing in equity and/or mezzanine funds.

3.2 Sectoral Challenges and Bank Objectives

The Bank will continue to focus on improving the competitiveness of enterprises and the diversification of energy sources in Estonia. Energy efficiency and renewable energy are also important objectives given the relatively large remaining transition gaps. The sectoral challenges and objectives outlined below would be pursued once the effects of the credit crisis have subsided and the commercial bank market has returned to normal operation.

3.2.1 Financial Sector

Crisis response/Transition Goals
While the financial sector is relatively well-developed, financial intermediation to the SME sector remains low in Estonia. There is a lack of equity and mezzanine capital to support economic

growth and improvements in competitiveness. In addition, access to long-term capital remains restricted in the current environment.

Operational Priorities

Crisis response measures:

- Immediate crisis response mainly focuses on providing long term capital to selected banks in order to improve their capitalisation and to support their lending to the corporate sector, particularly to the SMEs.

Other priorities:

- Selectively commit capital to new equity or mezzanine funds, mainly those focusing on SMEs.

3.2.2 Enterprise Sector

Crisis response/Transition Goals

Expansion of private enterprises, particularly in less developed regions and with cross-border activities, remains a key challenge. This will require continued improvements in the business environment, in access to capital and in administrative procedures to increase transfers of EU funds.

Operational Priorities

Crisis response measures:

- Provide support for continued investments at the company level in cases where commercial financing is not available or not sufficient.

Other priorities:

- Provide long-term debt and equity to companies to support their growth, competitiveness and environmental investments as well as cross-border investments, restructuring and corporate governance support.

3.2.3 Infrastructure and Energy

Crisis response/Transition Goals

There is limited private sector participation in municipal sectors, particularly water and sewage and in state transport infrastructure. There are significant unnecessary operating costs due to heat losses from municipal-owned heating networks and buildings and privatised industrial enterprises.

Operational Priorities

Crisis response measures:

- Encourage, where appropriate, private sector participation in the financing of municipal and transport infrastructure. Where possible these projects will be complemented with EU funding.
- Support commercial banks' lending to EU co-funded projects.

- Support energy efficiency investments through providing long term capital to commercial banks in co-operation with state authorities and other IFIs.

Other priorities:
- Contribute to energy security by supporting nationally important energy investments in close collaboration with other IFIs.
- Support the development of alternative energy sources, in particular renewable energy.

3.3 Portfolio management challenges

The Bank will structure its portfolio management in such a way that it is able to improve the current quality of the portfolio and ensure that project monitoring by the Vilnius Resident Office staff is proactive and of high standard. This will be supported by staying in close contact with local banks which are in a better position to assess the effects of the credit crisis on the local market.

4. ACTIVITIES OF OTHER IFIs, EU AND CO-OPERATION WITH EBRD

- **European Union (EU):** In the period of 2007 – 2013 Estonia was allocated over EUR 3.4 billion from the Structural Funds, which will be channelled to the following fields: energy economies, entrepreneurship, administrative capability, education, information society, environment protection, regional and local development, research and development activities, healthcare and welfare, transportation and labour market.

- **European Investment Bank (EIB):** Since 2005 EIB has committed financing to an amount of EUR 167 million in Estonia. The financed investments are EUR 40 million supporting the expansion of Port of Tallinn, EUR 25 million to Tallink, a ferry operator, to co-finance a new ferry, and EUR 32 million to support road enhancement and reconstruction schemes in the City of Tallinn. Another EUR 70 million has been provided financial institutions for onlending to SME sector. Recently EIB has signed an operation to an amount of EUR 550 million with the Republic of Estonia for the co-financing of EU Cohesion and Structural Funds in 2007 – 2013 and an a loan of EUR 150 million with Eesti Energija for the construction and upgrade of the transmission and distribution networks.

- **International Monetary Fund (IMF):** Estonia joined the IMF in 1992. The latest stand-by facility expired in August 2001. The Article IV consultations are held on the standard 12-month cycle. The latest Article IV consultation with the Republic of Estonia was concluded by the Executive Board of IMF on 2 March 2009.

- **World Bank (WB):** Estonia joined the World Bank in 1992. Since then WB commitments to the country have totalled USD 151 million for eight operations. Programmes focused on improving the environment, fostering private sector investment and growth, upgrading the efficiency of essential infrastructure. WB has no more active projects in Estonia. Estonia graduated from WB borrower status to that of a donor partner in September 2006.

- **International Finance Corporation (IFC):** Estonia joined IFC in 1993. Since then, IFC has invested over USD 100 million in 18 projects in various sectors. Following the country's accession to the EU, IFC has focused on the regions, sectors and projects where private financing remains limited, emphasising socially end environmentally sensitive sectors.

- **Nordic Investment Bank (NIB):** Estonia became a member of NIB in January 2005. However the NIB has been active in Estonia already before this through the Baltic Investment Programme. In 2007 – 2008 NIB has financed fore investment projects, EUR 20 million for financing of Tallina Vesi's investments, including the maintenance and extension of the water supply and sewage networks, EUR 40 million to finance Fortum Tartu's new CHP-plant, EUR 18 million to Tallinna Trammi ja Trollikoondis' for financing the renewal of the public transport service rolling stock and EUR 22 million to Tallinna Lennujaam to co-finance the rehabilitation of the airport's area and upgrade of the passenger terminal.

- **Kreditanastalt für Wiederaufbau (KfW):** KfW has provided financing to support the SMEs and housing renovation projects in Estonia. In 2005 KfW provided financing to all major banks in Estonia, loans totalling EUR 60 million and extended in co-operation with Council of Europe Development Bank were targeted to support small municipality development.

- **Council of Europe Development Bank (CEB):** Estonia became a member of CEB in April 1998. In 2008 CEB signed a loan with SEB bank for an amount of EUR 100 million to finance social sector investments in the Baltic states through SEB's subsidiaries, SEB Eesti Űhisbank in the case of Estonia. Also in 2008 CEB approved a project with KredEx (Credit and Export Guarantee Fund) to finance housing renovation in apartment buildings for an amount of EUR 35 million. However, this loan has not yet been signed.

ANNEX 1: COMMITTED PROJECTS PER YEAR

As of 30 March 2009 – EUR million

Year	Operation Name	Regional/Direct	Total Project Value	EBRD Finance	Debt	Equity
	Estonia Energy Sector Emergency Investment Project	Direct	26.5	24.7	24.7	0.0
1992	**1**		**26.5**	**24.7**	**24.7**	**0.0**
	Estline Marine Company Ltd	Direct	43.5	19.4	19.4	0.0
1993	**1**		**43.5**	**19.4**	**19.4**	**0.0**
	Tallinn Airport Rehabilitation Project	Direct	10.5	9.1	9.1	0.0
	Sampo Pank (formerly Optiva Pank) (credit line)	Direct	7.9	4.0	4.0	0.0
	Tallinn Water and Environment Project	Direct	74.6	22.7	22.7	0.0
	Hansapank (line of Credit)	Direct	17.2	2.6	2.6	0.0
	Estonian Investment Bank Capital Increase	Direct	4.5	1.5	0.0	1.5
	First NIS Regional Fund	Regional	0.5	0.3	0.0	0.3
1994	**6**		**115.2**	**40.2**	**38.4**	**1.8**
	Hansapank (formerly Eesti Hoiupank)	Direct	11.5	3.6	2.2	1.5
	Hansapank (formerly Eesti Hoiupank) (equity)	Direct	1.9	1.9	0.0	1.9
	Eesti Uhispank (Credit Line)	Direct	8.7	8.7	8.7	0.0
	Baltic Investment Fund	Regional	7.5	2.2	0.0	2.2
	Eurovision - Estonia	Direct	0.7	0.7	0.7	0.0
	Small Municipalities Environment Project	Direct	46.0	10.2	10.2	0.0
1995	**6**		**76.3**	**27.3**	**21.8**	**5.6**
	Hansapank (Credit Line)	Direct	0.3	0.3	0.3	0.0
	Hansapank Housing Loan	Direct	6.1	6.1	6.1	0.0
	Eesti Uhispank (credit line)	Direct	6.1	4.3	4.3	0.0
	Sampo Pank (Formerly Optiva Pank) (debt)	Direct	6.1	6.1	6.1	0.0
	New Europe Insurance Ventures	Regional	6.1	0.5	0.0	0.5
1996	**5**		**24.7**	**17.3**	**16.8**	**0.5**
	Hansapank (formerly Eesti Hoiupank) Housing Loan	Direct	7.7	7.7	7.7	0.0
	Sampo Pank (Formerly Optiva Pank) Subordinated Loan	Direct	2.0	2.0	2.0	0.0
	Eesti Uhispank (formerly Tallinna Pank - Subordinated loan)	Direct	2.6	2.6	2.6	0.0
	Eesti Maapank Equity Investment	Direct	1.5	1.5	0.0	1.5
	Hansapank - Subordinated Debt	Direct	7.7	7.7	7.7	0.0
	Eesti Uhispank - Housing Loan	Direct	6.1	6.1	6.1	0.0
	Hansapank (formerly Eesti Hoiupank) Sub Debt (equity)	Direct	25.5	25.5	12.8	12.7
	Baring Communications Equity	Regional	2.5	0.5	0.0	0.5
	Baltic Small Equity Fund	Regional	3.1	1.5	0.0	1.5
	Imavere Sawmill Expansion Project	Direct	16.8	7.1	7.1	0.0
1997	**10**		**75.5**	**62.2**	**46.0**	**16.2**
	Eesti Uhispank Increase to Subordinated Debt	Direct	5.1	5.1	5.1	0.0
	Hansapank Increase of the Subordinated Debt	Direct	7.7	7.7	7.7	0.0
	Eesti Uhispank DEM 40m Long Term Credit Line	Direct	20.5	16.6	16.6	0.0
	AS Norma	Direct	8.1	4.1	4.1	0.0
	Innova/98 LP	Regional	1.9	0.4	0.0	0.4
	Hansapank Convertable Sub Debt (equity)	Direct	10.2	10.2	5.1	5.1
	Hansapank Syndicated Loan	Direct	76.7	25.6	25.6	0.0
	Baltex 2000 / Qualitex	Direct	24.0	5.6	3.1	2.6
	Baltex 2000 / Qualitex (Phoenix Capital Rebooking)	Direct	1.8	1.8	1.8	0.0
	Baltex 2000 / Qualitex write-off	Direct	1.3	1.3	1.3	0.0
	IO Fund - Bunim-Welding	Direct	0.3	0.3	0.0	0.3
1998	**11**		**157.6**	**78.7**	**70.4**	**8.4**

	Tallinn Airport Passenger Terminal Reconstruction		Direct	23.1	7.6	7.6	0.0
	PPF - Baltic - Tallegg		Direct	2.9	2.8	0.0	2.8
	Info. and Comm. Tech & Industrial Electronic Fund Ltd.		Regional	2.7	0.6	0.0	0.6
	Hansa Capital Syndicated Leasing Finance Facility (debt)		Direct	40.0	13.3	13.3	0.0
	Imavere Sawmill Expansion II		Direct	7.4	5.1	5.1	0.0
	Emerging Europe Capital Investors LDC		Regional	7.9	2.2	0.0	2.2
1999		**6**		**84.0**	**31.6**	**26.0**	**5.6**
	Baltic Food Holding		Direct	39.2	5.5	0.0	5.5
	Estonia: MSE Facility - Hansapank		Direct	17.9	5.0	5.0	0.0
	PPF - Baltic -MicroLink		Direct	1.9	1.8	0.0	1.8
	Estonia: MSE Facility - Eesti Uhispank (credit line)		Direct	11.0	3.0	3.0	0.0
	Baltic Investment Fund III		Regional	18.0	3.3	0.0	3.3
	EU/EBRD Phase II - Sampo Pank		Direct	8.0	8.0	8.0	0.0
2000		**6**		**96.0**	**26.6**	**16.0**	**10.6**
	DVI, Inc. (debt)		Regional	2.1	0.6	0.6	0.0
	EU/EBRD Phase I - Baltic SME Fund		Regional	5.5	1.0	0.0	1.0
	Fiesta		Regional	12.2	6.9	6.9	0.0
	Kesko Baltics		Regional	15.7	5.5	5.5	0.0
	Pleskodale		Regional	5.8	3.8	3.8	0.0
2001		**5**		**41.3**	**17.8**	**16.8**	**1.0**
	Imavere Sawmill III		Direct	12.3	7.0	7.0	0.0
	LHV Asset Management (equity)		Direct	2.8	1.1	0.0	1.1
	Tallinn Airport Loan		Direct	7.3	7.3	7.3	0.0
	Tallinn Water Privatisation Financing Project		Direct	172.8	55.0	55.0	0.0
	Askembla Growth Fund		Regional	14.5	5.0	0.0	5.0
	Heitman Central Europe Property Partners Fund II		Regional	3.6	1.1	0.0	1.1
2002		**6**		**213.3**	**76.5**	**69.3**	**7.2**
	ORCO APARTHOTELS		Regional	16.8	2.2	0.4	1.7
	EU/EBRD Extension 4 - Hansa Capital		Regional	10.2	5.1	5.1	0.0
	International Water United Utilities		Regional	30.7	11.2	0.0	11.2
2003		**3**		**57.7**	**18.5**	**5.5**	**12.9**
	Polish Enterprise Fund V		Regional	1.4	1.4	0.0	1.4
	Estonian Cell		Direct	153.0	19.0	14.0	5.0
	Europolis II		Regional	9.0	2.3	1.7	0.6
2004		**3**		**163.4**	**22.7**	**15.7**	**7.0**
	Emerging Europe Convergence Fund II		Regional	3.6	3.6	0.0	3.6
	Argus Capital Partners II		Regional	0.3	0.3	0.0	0.3
	SG AM Eastern Europe L.P.		Regional	3.3	3.3	0.0	3.3
2005		**3**		**7.2**	**7.2**	**0.0**	**7.2**
	Baltcap Private Equity Fund		Regional	6.0	6.0	0.0	6.0
	EnerCap		Regional	10.0	2.5	0.0	2.5
	Iberdrola Estonia Wind		Direct	2.6	0.9	0.0	0.9
	Royalton Partners II		Regional	2.5	2.5	0.0	2.5
2007		**3**		**21.1**	**11.9**	**0.0**	**11.9**
TOTAL		**75**		**1,203.3**	**482.6**	**386.7**	**95.9**

ANNEX 2: NET CUMULATIVE BUSINESS BY INDUSTRY

As of 31st April 2009 – EUR million

Sector Team (SIC)	EBRD Finance	Debt	Equity	Private	State	Portfolio Ratio*	% Share of Commitments	Total Project Value
Corporate								
Agribusiness	22	16	5	22	0	100%	4%	29
General Industry	51	43	8	51	0	100%	11%	51
Property and Tourism	5	2	3	5	0	100%	1%	5
Telecoms Informatics & Media	2	1	1	1	1	67%	0%	2
Sub-total Corporate	**80**	**62**	**17**	**79**	**1**	**99%**	**17%**	**87**
Energy								
Power and Energy	28	25	3	3	25	12%	6%	28
Sub-total Energy	**28**	**25**	**3**	**3**	**25**	**12%**	**6%**	**28**
Financial Institutions								
Bank Equity	24	0	24	24	0	100%	5%	49
Bank Lending	149	149	0	149	0	100%	31%	212
Equity Funds	41	0	41	41	0	100%	8%	48
Non Bank Financial Institutions	20	19	1	20	0	100%	4%	54
Sub-total Financial Institutions	**234**	**168**	**66**	**234**	**0**	**100%**	**49%**	**363**
Infrastructure								
Municipal & Env Inf	99	88	11	66	33	67%	21%	124
Transport	40	40	0	17	23	42%	8%	46
Sub-total Infrastructure	**140**	**128**	**11**	**83**	**56**	**60%**	**29%**	**170**
ESTONIA TOTAL	**481**	**383**	**98**	**400**	**82**	**83%**	**100%**	**648**

DEBT	383	383	0	301	82
EQUITY	98	0	98	98	0
GUARANTEE	0	0	0	0	0
Direct	399	359	39	317	82
Regional	83	24	59	83	0

PRIVATE	400	301	98	400	0
STATE	82	82	0	0	82

	481	383	98	400	82

ANNEX 3: SELECTED ECONOMIC INDICATORS

	2003	2004	2005	2006	2007	2008 *Estimate*	2009 *Projection*
Output and expenditure			*(Percentage change in real terms)*				
GDP	7.6	7.2	9.4	10.0	7.2	-3.6	-13.2
Private consumption	8.6	9.6	9.9	13.0	9.1	-4.8	na
Public consumption	0.8	2.0	-0.2	3.5	3.7	4.1	na
Gross fixed capital formation	18.6	5.2	15.4	18.5	9.0	-12.1	na
Exports of goods and services	7.4	14.6	18.6	14.0	0.0	-0.7	na
Imports of goods and services	10.1	14.4	17.5	22.9	4.7	-8.7	na
Industrial gross output	8.4	9.0	12.8	12.3	8.4	-4.8	na
Agricultural gross output	2.3	-9.2	-4.3	-3.2	-10.4	6.3	na
Employment			*(Percentage change)*				
Labour force (annual average)	1.2	-0.2	0.1	4.1	0.1	1.1	na
Employment (annual average)	1.5	0.2	2.0	6.4	1.4	0.2	na
			(In per cent of labour force)				
Unemployment (annual average)	10.0	9.6	7.9	5.9	4.7	5.5	na
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	1.3	3.0	4.1	4.4	6.6	10.4	0.2
Consumer prices (end-year)	1.1	5.0	3.6	5.1	9.6	7.0	na
Producer prices (annual average)	0.2	2.9	2.1	4.5	8.3	7.1	na
Producer prices (end-year)	0.3	3.9	2.2	5.9	8.7	5.2	na
Gross average monthly earnings in economy (annual average)	9.4	8.4	10.8	16.5	20.5	13.9	na
Government sector			*(In per cent of GDP)*				
General government balance	1.7	1.6	1.5	3.3	2.6	-2.9	-3.5
General government expenditure	34.8	34.0	33.8	33.5	34.7	40.3	na
General government debt	5.6	5.0	4.5	4.2	3.4	4.7	na
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	10.9	15.8	42.0	28.2	13.4	5.5	na
Domestic credit (end-year)	28.7	29.2	32.1	41.9	34.2	8.1	na
			(In per cent of GDP)				
Broad money (M2, end-year)	36.8	38.4	47.2	51.2	49.1	50.4	na
Interest and exchange rates			*(In per cent per annum, end-year)*				
Deposit rate (over 12 months)	2.4	2.1	3.0	4.1	5.6	6.0	na
Lending rate (over 12 months)	5.1	6.2	9.2	7.7	9.7	11.1	na
			(Kroons per US dollar)				
Exchange rate (end-year)	12.4	11.5	12.5	11.9	10.6	11.1	na
Exchange rate (annual average)	13.9	12.6	12.4	12.5	11.4	10.7	na
External sector							
			(In millions of US dollars)				
Current account	-1,116.3	-1,369.5	-1,386.8	-2,816.0	-3,803.8	-2,235.8	210.0
Trade balance	-1,556.7	-1,947.7	-1,920.4	-3,010.9	-3,816.0	-2,759.7	-962.0
Merchandise exports	4,595.8	5,929.5	7,879.1	9,755.6	11,089.4	12,572.5	9,453.0
Merchandise imports	6,152.5	7,877.2	9,799.5	12,766.5	14,905.4	15,332.2	10,415.0
Foreign direct investment, net	762.7	697.8	2,255.1	675.8	999.5	880.1	-50.0
Gross reserves, excluding gold (end-year)	1,373.4	1,792.5	1,945.1	2,855.9	3,330.0	3,913.0	na
External debt stock [1]	7,064.7	10,173.6	11,446.7	16,992.4	25,502.8	26,820.9	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	2.2	2.2	1.9	2.2	2.2	2.5	na
			(In per cent of exports of goods and services)				
Debt service	11.2	12.5	12.9	14.4	14.9	na	na
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	1.4	1.4	1.3	1.3	1.3	1.3	na
GDP (in billions of kroons)	136.4	151.5	175.0	207.0	244.5	251.5	218.7
GDP per capita (in US dollars)	7,258.5	8,903.8	10,495.7	12,340.5	15,930.7	16,690.4	na
Share of industry in gross value added (in per cent)	25.4	24.8	25.3	25.8	25.8	25.3	na
Share of agriculture in gross value added (in per cent)	3.6	3.4	3.1	2.7	2.4	2.3	na
Current account/GDP (in per cent)	-11.3	-11.4	-9.8	-17.0	-17.8	-9.5	1.1
External debt - reserves (in US$ million)	5,691.3	8,381.1	9,501.6	14,136.5	22,172.8	22,907.9	na
External debt/GDP (in per cent)	71.8	84.6	80.9	102.4	119.3	114.0	na
External debt/exports of goods and services (in per cent)	103.6	115.9	102.9	128.1	164.7	151.0	na

[1] Data from the Bank of Estonia and include non-resident currency and deposits, liabilities to affiliated enterprises and liabilities to direct investors.

ANNEX 4: STRUCTURAL CHANGE INDICATORS

	2003	2004	2005	2006	2007	2008	2009
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	7.2	7.3	na	na	na	na	na
Private sector share in GDP (in per cent)	80.0	80.0	80.0	80.0	80.0	80.0	na
Private sector share in employment (in per cent)	73.7	74.5	75.5	74.8	75.9	na	na
Budgetary subsidies and current transfers (in per cent of GDP)	1.1	1.3	0.7	0.6	0.6	na	na
Share of industry in total employment (in per cent)	25.2	27.0	26.0	23.8	22.9	na	na
Change in labour productivity in industry (in per cent)	4.3	1.7	14.9	15.1	11.4	na	na
Investment/GDP (in per cent)	33.2	34.3	34.2	38.6	37.9	30.1	na
EBRD index of small-scale privatisation	4.3	4.3	4.3	4.3	4.3	4.3	na
EBRD index of large-scale privatisation	4.0	4.0	4.0	4.0	4.0	4.0	na
EBRD index of enterprise reform	3.3	3.3	3.7	3.7	3.7	3.7	na
Markets and trade							
Share of administered prices in CPI (in per cent) [2]	24.9	26.9	26.7	24.7	23.3	na	na
Number of goods with administered prices in EBRD-15 basket	3.0	3.0	2.0	2.0	2.0	na	na
Share of trade with non-transition countries (in per cent)	72.0	72.0	72.6	68.4	66.9	na	na
Share of trade in GDP (in per cent)	109.5	114.8	124.8	137.1	123.6	120.1	98.0
Tariff revenues (in per cent of imports)	0.1	0.2	0.3	0.3	0.3	na	na
EBRD index of price liberalisation	4.3	4.3	4.3	4.3	4.3	4.3	na
EBRD index of forex and trade liberalisation	4.3	4.3	4.3	4.3	4.3	4.3	na
EBRD index of competition policy	3.0	3.3	3.3	3.7	3.7	3.7	na
Financial sector							
Number of banks (foreign-owned)	7 (4)	9 (6)	13 (10)	14 (12)	15 (13)	na	na
Asset share of state-owned banks (in per cent)	0.0	0.0	0.0	0.0	0.0	na	na
Asset share of foreign-owned banks (in per cent)	97.5	98.0	99.4	99.1	98.7	na	na
Non-performing loans (in per cent of total loans)	0.5	0.3	0.2	0.2	0.5	na	na
Domestic credit to private sector (in per cent of GDP)	30.7	39.7	57.0	78.2	89.3	na	na
Domestic credit to households (in per cent of GDP)	14.3	19.7	28.1	38.2	43.3	na	na
Of which mortgage lending (in per cent of GDP)	9.5	14.6	22.6	33.0	37.7	na	na
Stock market capitalisation (in per cent of GDP)	38.4	47.1	25.2	34.6	26.9	na	na
Stock trading volume (in per cent of market capitalisation)	18.3	17.5	51.1	20.5	34.9	na	na
Eurobond issuance (in per cent of GDP)	5.8	8.1	2.5	na	0.2	na	na
EBRD index of banking sector reform	3.7	4.0	4.0	4.0	4.0	4.0	na
EBRD index of reform of non-bank financial institutions	3.3	3.3	3.3	3.7	3.7	3.7	na
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	34.1 (77.7)	33.3 (94.1)	33.3 (108.8)	34.1 (125.2)	37.1 (148.4)	na	na
Internet users (per 100 inhabitants)	44.4	50.2	51.9	55.1	58.4	na	na
Railway labour productivity (1989=100)	256.5	294.4	359.7	348.0	285.2	na	na
Residential electricity tariffs (USc kWh)	6.5	8.1	9.2	10.1	10.2	12.1	na
Average collection rate, electricity (in per cent)	99	99	99	99	99	99	na
GDP per unit of energy use (PPP in US dollars per kgoe)	3.6	3.8	4.4	na	na	na	na
EBRD index of infrastructure reform	3.3	3.3	3.3	3.3	3.3	3.3	na
Electric power	3.0	3.0	3.0	3.3	3.3	3.3	na
Railways	4.3	4.3	4.3	4.3	4.0	4.0	na
Roads	2.3	2.3	2.3	2.3	2.3	2.3	na
Telecommunications	4.0	4.0	4.0	4.0	4.0	4.0	na
Water and waste water	4.0	4.0	4.0	4.0	4.0	4.0	na

[1] Estonia has no specific concession law but generally conforms with internationally accepted principles on concession laws.

[2] The high share is explained by the inclusion of gasoline (on which there are excise taxes) in the calculations of the Statistical Office.

ANNEX 5: POLITICAL AND SOCIAL ASSESSMENT

Estonia continues to meet the conditions specified in Article 1 of the Agreement Establishing the Bank.

Political Context

Since the restoration of independence in 1991, Estonia has made remarkable progress in building and consolidating its democratic institutions and a functioning market economy. The executive branch is headed by the president, who is elected indirectly by the parliament, the *Riigikogu*, for a five-year term. However, the president's powers are largely formal, and most executive functions are carried out by the government, led by the prime minister. The judiciary is independent and is widely perceived as both professional and efficient.

Since independence, Estonia has conducted five parliamentary elections, all of which have been deemed free and fair by international observers. While the party system is generally more stable than in many other CEB countries, elections in Estonia have often resulted in the formation of multiparty coalition governments which have proven to be fragile, and the party composition of Estonia's coalition governments therefore fluctuates frequently. While this has often slowed policymaking, however, the fragmentation of Estonia's party system has not resulted in any significant reform reversals.

The most recent parliamentary elections, in March 2007, resulted in the formation of a three-party coalition government, including the economically liberal Reform Party (ER) led by Prime Minster Andrus Ansip, the conservative Pro Patria-Res Publica (IRL) Union and the centre-left Social Democratic Party (SDE). The three-party coalition enjoyed a comfortable majority of 60 of the 101 seats in parliament until late-May 2009. Despite this relatively long-lasting majority, ideological differences coupled with permanent electoral jockeying among the governing parties stymied progress on Estonia's remaining structural reform agenda.

The current environment of financial and economic crisis has severely tested the government's capacity to maintain inter-party consensus and implement anti-crisis policies. The government was able to adopt a revised budget in February 2009 and a package of further spending cuts in April 2009, but only under the threat of a vote of confidence should the budget not be adopted. The coalition government was reduced to a minority of 50 seats in late-May 2009 when the Social Democrats left the coalition over disagreements about the spending cuts necessary to meet the Maastricht criterion of a budget deficit of 3 per cent. The parties now in opposition – the Centre Party, the Social Democrats, the Greens and the Estonian People's Party – could in theory form a government with their 50 seats plus the support of parliament's one independent MP, a former Centre Party member. However, ideological differences between those parties as well as the desire to avoid electoral blame for the economic crisis make such a coalition difficult.

Integrity Issues

Early in the transition process Estonia implemented sweeping reforms to its institutions of governance, including the virtually wholesale replacement of the country's civil service. As a result, Estonia now has the strongest governance institutions in the transition region, according to the World Bank's Worldwide Governance Indicators: Estonia's score on the 'Government Effectiveness' index, for example, is close to the OECD average, on a par with OECD countries such as France and significantly stronger than other EU member countries, such as Italy and Greece. Regulatory quality is also very high in Estonia, indeed higher than the OECD average on the ‘Regulatory Quality’ index of the Worldwide Governance Indicators, and eclipsing many OECD member countries, such as South Korea.

Neither petty nor high-level corruption are significant problems in Estonia, which has one of the most transparent and business-friendly investment climates in Europe. According to Transparency International’s Corruption Perceptions Index, Estonia was ranked 27th of 180 countries globally in 2008, a position the country has maintained for a number of years. The perception of low levels of corruption is driven in large part by the effective rule of law in Estonia: Estonia is the top-ranked transition country on the Rule of Law index of the World Bank’s Worldwide Governance Indicators, although it falls somewhat below the OECD average. The close relationship between the political and business elite, which is difficult to avoid in countries as small as Estonia, fuels concerns about the risks of political corruption, but stringent anti-corruption measures have long been in place to limit the possibilities for state capture.

Social Conditions

Population

Estonia’s population stood at an estimated 1.34 million as of 1 January 2009, representing a decline of 14.7 per cent from the population of 1.57 million recorded in 1990. A significant proportion of this decline resulted from the emigration of ethnic Russians following the collapse of the Soviet Union, with the largest annual falls recorded between 1993 and 1995. The proportion of the population over the age of 60 is higher than the European average, at 22.2 per cent in 2009, and has been steadily rising since 1990. As a result, Estonia faces many of the same challenges associated with an ageing population as are being faced in western European states. Despite a high concentration of population the capital Tallinn, more than one-third of the population continues to live in rural municipalities, and that percentage has risen since 2006.

Minorities

In 2008, 68.7 per cent of the population was ethnic Estonians and 25.6 per cent of the population ethnic Russians. Those ratios have remained virtually unchanged over the past decade. The ethnic Russian population is concentrated in Tallinn and in Estonia’s northeast. The remaining 5.7 per cent of the population in 2008 was made up of small numbers of Ukrainians, Belarussians, Finns and other minority ethnic groups.

Estonia’s legal framework for the protection of minority rights is well developed. Estonia has ratified all key international human rights instruments, including the Framework Convention for the Protection of National Minorities. Moreover, in response to concerns expressed by the Council of Europe, OSCE and European Commission in the mid-1990s, Estonia undertook a series of amendments to its citizenship legislation to ease the requirements for residents to secure Estonian citizenship. In response to those measures the OSCE ended regular human rights monitoring reports for Estonia.

According to government statistics, approximately 8.2 per cent of the population were resident aliens or of undetermined citizenship in 2008. The Estonian government remains committed to creating possibilities for minority groups to receive education in their mother tongue and maintaining their culture, while supporting the integration of the country's non-Estonian minorities, including subsidising Estonian language training for all non-native speakers. The overwhelming majority of Estonia's resident alien population possess resident permits, have the right to vote in local (but not national) elections, and have access to social security.

Poverty

Absolute poverty is not a major problem in Estonia. However, income inequality is high in relation to the transition region average, with a Gini coefficient of 33.4 (where 0=total income equality) recorded in 2006. Poverty is concentrated in rural areas and is particularly acute among women at either end of the age range. While the current period of sharp economic contraction is likely to have a levelling effect on incomes, the steep rise in unemployment is also likely to hit the poorest segment of the population particularly hard.

Education

Estonia has one of the highest levels of literacy in Europe at 99 per cent of the adult population. Education is compulsory from the age of seven to 17, and more than 95 per cent of primary school students advance to secondary education, where students have a choice of attending either vocational or comprehensive secondary schools. Since independence, Estonia's vocational education system has been restructured to more flexibly meet the needs of the labour market. Higher education is also increasingly popular in Estonia. Commercial considerations play a large role in Estonian students' choices of degree, with more than 20 per cent studying for degrees in business and administration. The primary challenge for the Ministry of Education remains the integration of Russian-language primary and secondary schools into the Estonian-language dominated state schooling system. By 2007, all primary and secondary school graduates were required to be sufficiently fluent in Estonian to continue further studies in the language; by 2011, 60 per cent of all teaching in Russian-language secondary schools will be in Estonian.

Health

Health indicators declined precipitously in the early 1990s in the wake of Estonia's post-Soviet economic contraction. Life expectancy at birth fell sharply, to a low of 60.5 years for men in 1994, but has since recovered: in 2007 life expectancy for women was 78.7 years, although for men it remains low by EU standards, at 67.1 years. Infant mortality reached a post-independence peak of 15.7 deaths per 1,000 live births in 1992, and has been declining steadily since to reach 5.0 deaths per 1,000 live births in 2008, according to the national statistics office. The share of persons with bad or very bad health (as defined by the Laeken indicators) in the lowest income quintile of the population was 27.5 per cent in 2007, a relatively steep rise from the 19.9 per cent recorded in 2004. For the highest income quintile, only 3.5 per cent of the population reported bad or very bad health, down from 4.2 per cent reported in 2004.

Labour Issues

Unemployment in Estonia reached its post-independence high of 13.6 per cent (according to ILO methodology) in H2 2000. After 2000, the unemployment rate fell rapidly to reach 4.7 per cent at year-end 2007, on the back of very high demand for labour resulting from Estonia's rapid growth rate. However, since reaching a low point in Q2 2008, unemployment has once again risen sharply with the onset of the economic crisis, to reach 11.4 per cent nationwide in Q1 2009.

Moreover, the regional variation in unemployment rates is extremely high, with unemployment in northeastern Estonia, at 13.6 per cent, almost twice as high as in western Estonia, at just 7.3 per cent.

The basis of Estonian labour law, the Employment Contracts Act of 1992 and subsidiary legislation such as the Collective Labour Dispute Resolution Act of 1993 provide the rights to workers to form and join trade unions and for unions to conduct their operations without interference from the government. The law prohibits discrimination against unions, and both employees and employers have the right to request that labour dispute committees or the courts resolve individual disputes. However, trade unions in Estonia are weak, with a membership of approximately 10 per cent of the workforce in 2008, a significant decline from 37 per cent of the workforce in 1994, while a total of 15 per cent of the workforce is covered by collectively bargained contracts, and the Confederation of Estonian Trade Unions alleges that violations of trade union rights are frequent and that labour inspectorates are not efficient in enforcing the law.

ANNEX 6: COMMERCIAL LAWS OF ESTONIA

The EBRD has developed and regularly updated a series of assessments of legal transition in its countries of operation, with a focus on selected areas relevant to investment activities: capital markets, company law and corporate governance, concessions, insolvency, secured transactions and telecommunications. The existing tools assess both the quality of the laws "on the books" (also referred to as "extensiveness") and the actual implementation of such laws (also referred to as "effectiveness"). All available results of these assessments can be found at www.ebrd.com/law. This annex presents a summary of the results for Estonia, accompanied by critical comments of the Bank's legal experts who have conducted the assessments.

Company Law and Corporate Governance

The Commercial Code (1995) is the primary legislation concerning corporate matters and governance in Estonia. The Commercial Code has been amended several times since our last country strategy report. In December 2007, the Commercial Code was amended to transpose the Cross Border Mergers Directive, simplifying the procedures applicable to the merger of limited liability companies registered in EU State members.

In April 2008, Estonian company law was harmonised with Directive 2006/68/EC and Directive 77/91/EEC and consequently amended with respect to the incorporation of public limited liability companies and the alteration of their share capital.

It was last amended in December 2008, with the introduction of some restrictive rules applicable to the appointment of the board of directors' and the supervisory board's members in order to prevent the use of forged documents and appointments of members unknown to the shareholders (Act Amending the Commercial Code, the Penal Code and Associated Act dated 19 December 2008).

A voluntary corporate governance code was adopted in Estonia on 1 January 2006. Furthermore, some "Corporate Governance Recommendations" were developed by the Financial Supervisory Authority (FSA) in co-operation with the Tallinn Stock Exchange (TSE) and are intended to enhance corporate governance and transparency among listed companies. Pursuant to TSE rules, listed companies are required to report their compliance with the Recommendations on a "comply or explain" principle. The FSA considers that the reports which have been published by the issuers whose securities are traded on the TSE have been satisfactory.

In 2005, the EBRD launched a survey for testing the effectiveness of corporate governance (how the law works in practice). A case study dealing with related-party transactions was designed. The case study investigated the position of a minority shareholder seeking to access corporate information in order to understand if a related-party transaction was indeed entered into by the company and on how it was possible to obtain compensation in case damage was suffered. Effectiveness of legislation was then measured according to four principal variables: complexity, speed, enforceability and institutional environment.

The survey revealed that actions to obtain disclosure available to minority shareholders having less than 25 per cent shareholding are limited and in general not very effective (minority shareholders can call a general meeting to request information from the management, but they cannot make any decisions unless their action is backed by the controlling shareholders). When considering redress, actions available to minority shareholders are also limited, although much more effective. In this respect, procedures are deemed clear and enforceability is generally not considered a particular issue, although the outcome depends on the solvency of the debtor. Obtaining an executable judgement can take more than two years and it is considered easy for the defendant to further delay the proceedings. Finally, the institutional environment is considered sound as courts are deemed impartial and generally competent in corporate law cases, corporate information is reliable and statutory auditors are deemed fairly independent from the controlling shareholder.

Concessions

Estonia does not have a single-act general framework Concessions Law. Instead, the country governs private sector participation in public projects and concessions by a mixture of general law and sector-by-sector legislation. Furthermore, on governmental level there seems to be no clear policy framework for promoting PPP and improving the legal environment in the area.

Concession-related issues are regulated by the 2001 Competition Act and the 2007 Public Procurement Act. In particular, the former regulates the granting of "special or exclusive rights" and the latter regulates the granting of a "construction work concession" and other contracts concluded by public authorities above certain thresholds. General provisions on contractual arrangements which could be agreed in the context of a concession can also be found in the Contracts and Extra-Contractual Obligations Act. However, the application of one general law over the other is not simple to determine. The procedure to be followed is rather vague in the sector specific laws that refer to the general law (Competition Act or Public Procurement Act).

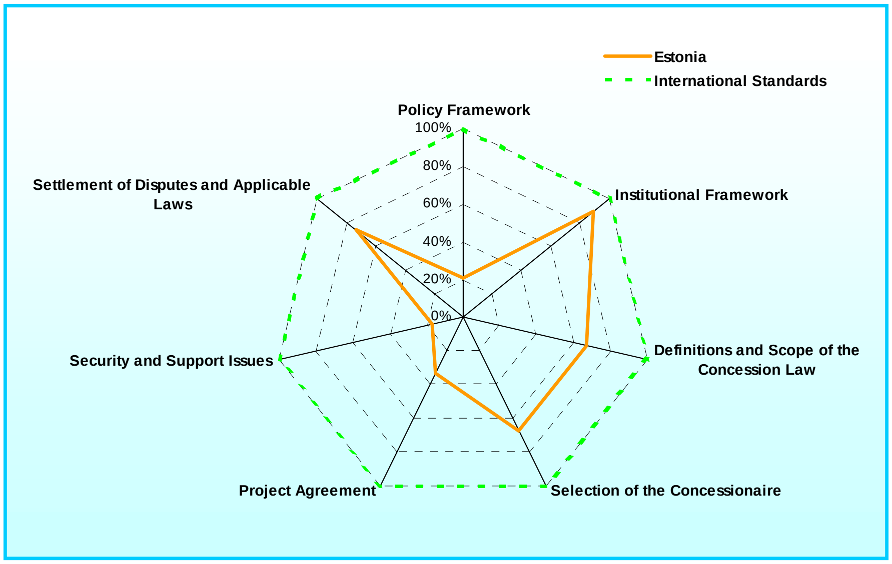
Sector specific legislation does not refer directly to concessions, even when the regulation of certain activities (e.g. transport) allows concession-type arrangements. Some sector specific acts regulate the right of a private legal entity to use public assets in order to provide facilities or services to the public.

According to the Railways Act, the Railway Administration may grant licences to perform certain activities/services in connection with the operation and/or maintenance of a railway system. The licences may be granted to private entities listed in the commercial register. A foreign company may only be awarded an operational licence if it operates through a branch listed in the commercial register. The following types of licence exist: construction, management and the operation of railway infrastructure. Operating licences are issued for an unspecified term and are not transferable. They may be withdrawn under conditions stated in the Railways Act, but the licensee has to be given the opportunity to rectify the deficiencies that constitute the basis for a revocation. In order to obtain a license, the applicant has to fulfil a number of prerequisites stated in the Railways Act. A tendering procedure, or any other form of selection procedure, is not regulated in the Railways Act. However, this is counter-balanced by the clearly defined prerequisites that have to be met by the licensee thus ensuring a certain level of transparency.

The Water Supply and Sewage Act and the Water Act only provide for a framework for the privatisation of the water supply and sewage sector, and concessions are not awarded in these sectors.

The EBRD 2007/8 Assessment of Concession legislation found Estonian laws to be in “medium compliance” with the best internationally accepted standards (see chart below) with rules related, in particular, to security and state support as well as project agreements having the most potential for improvement.

Quality of concession legislation – Estonia (2007/8)



Note: the extremity of each axis represents an ideal score in line with international standards such as the UNCITRAL Legislative Guide for Privately Financed Infrastructure projects. The fuller the 'web', the more closely concessions laws of the country approximate these standards.

Source:
EBRD Concessions Sector Assessment 2007/8

Insolvency

Bankruptcy and insolvency in Estonia are governed by the Bankruptcy Act of 2003 (the "Bankruptcy Act") and the recently adopted Reorganisation Act of 2008 (the "Reorganisation Act"). The EBRD regularly makes commercial laws assessments and the next Insolvency Sector Assessment will be completed in late 2009 which will include evaluation of the effect of the latter act as well as any recent changes.

The previous insolvency assessment that was conducted in 2006 and did not take into account the Reorganisation Act of 2008, revealed that the Bankruptcy Act is relatively sound and contains a number of positive features, but is in need of improvement in several areas.

Among the positive features, the Bankruptcy Act contains adequate provisions detailing: the financial condition that triggers insolvency and the evidence required to establish such condition, the process for hearing and determining applications, and the qualifications required for an insolvency administrator. In addition, the Bankruptcy Act contains particularly well-detailed provisions for the avoidance of pre-bankruptcy transactions.

Despite these positive features, the last EBRD's assessment had identified several areas that needed improvement: the lack of a modern rehabilitation (reorganisation) process and the lack of a full discharge or release of debts at the conclusion of the full bankruptcy process. Additionally, clarification of the rights/position of secured creditors and inclusion of provisions for cross-border insolvency would also be beneficial.

The first issue identified by the EBRD as mentioned above has been tackled with the adoption of the Reorganisation Act. Reorganisation is new in the Estonian legal environment and should serve as an alternative to bankruptcy. Its purpose is to overcome economic difficulties, restore liquidity, improve profitability and ensure sustainable management. Reorganisation is a remedial measure offered to the debtors who are willing to stay in business. Thus it is the obligation of the company filing a petition for reorganisation, to prove its worthiness, including by testifying under oath before the court regarding its financial standing. The Act provides a set of measures applicable to the commencement of proceedings; the appointment and duties of the reorganisation advisor who serves as the immediate supervisor of the rehabilitation plan's implementation; the rules for the stay, as well as, the adjustment of claims. The Act constitutes a big step towards improving the chances for sustainability of business entities while reducing the number of liquidations.

Secured Transactions

Secured Transactions in Estonia are governed by the Law on Property of 1993 and the Law on Commercial Pledge of 1996. In 2003, amendments to the Property Law were adopted which created a system allowing taking security over rights (generally all intangible property). Other, less substantial changes have since been made to both acts.

In order to take security over personal (movable) property, the three main legal instruments are:
1. (non-possessory) registered charges over assets whose title is already registered in a specific registry (i.e. vehicles, aircraft, boats, intellectual property rights, etc), as governed by the Property Law;
2. so-called commercial pledges, which encumber the whole of an enterprise, hence sometime referred to as enterprise charges, governed by the Commercial Pledge Law and Property Law; and
3. charges over rights (that is claims, accounts receivables, rights over real property, etc), governed by the new specific provisions of the Property Law.

This system is fairly strict in that it does not allow the parties to define the collateral as they wish. For instance, the commercial pledge could not cover only part of the enterprise: the object of a commercial pledge must be the "economic unit through which an undertaking operates". Moreover, commercial pledges (enterprise charges) can only be granted by enterprises which are registered in the commercial register.

A registered or commercial pledge requires the notarisation of the charge agreement and the fees vary pro rata to the amount of the secured debt. Commercial pledges (enterprise charges) must be registered in the commercial pledge register, which is run by the Register Centre of the Ministry of Justice ("Kommertspandiregister").

The Property Law provides for realisation of the charged assets through a sale by public auction but it also allows the parties to agree to a different method of sale. The creditor is liable for damages if he does not comply with the agreement for the method of sale. The Supreme Court held in 2002 that such an agreement of purchase and sale should be in accordance with fair practice. In a survey on enforcement of charges conducted by the EBRD in 2003, results for Estonia showed that the enforcement system works efficiently: secured creditors are able to realise the secured assets speedily at a good return. Contrary to what happens to neighbouring jurisdictions, secured creditors seem to prefer enforcing through courts rather than directly because of the lack of practice on out-of-court enforcement.

Mortgages are governed by the Law on Property of 1993 (as later amended). Mortgage registration is done based on a notarised mortgage agreement or a notarised declaration of the owner's will to create a mortgage. Mortgage can secure any type of debt as far as it is within the limits set as the mortgage value. In legal terms, a mortgage is a non-accessory security and the legal connection between the secured claim and mortgage is made in a separate contractual arrangement. Any type of immovable property may be used for security. The Land Register is held by local courts under supervision of the Ministry of Justice. The database is centralised and fully electronic, and on-line searches of the Land Register can be made against the number or address of a property. Mortgage right enjoys priority in the mortgaged property from the moment of its entry in the Register. Priority is upheld in practice and in the event of bankruptcy.

In the case where a mortgagor defaults, the mortgage can be enforced based on a court decision or an immediate enforcement clause agreed in the mortgage agreement, through mandatory administration of the property or by public auction led by a bailiff appointed by the Enforcement Department (which is a special governmental body linked to the Ministry of Justice). Enforcement is reported to work fast but the obtained sale proceeds are somewhat below the market price.

The legal regime on charges over rights is comparable to conditional assignment: it requires the sub-debtor to be notified of the existence of the charge and the creditor can enforce the charge by receiving direct payment from the sub-debtor.

Securities Markets

In Estonia the basic legislation on the securities market is comprised by the Securities Market Act (2001), last amended in October 2007, setting forth the regulatory framework for the operation of the Estonian Securities Market, inter alia governing the provision of investment services, regulated market and stock exchange, initial public offering of securities, settlement of transaction with securities and other relevant matters; the Investment Fund Act (2004) stipulating requirements regarding collective investment schemes; the Financial Supervision Authority Act (2002) providing legal basis for Financial Supervision Authority activities; the Money Laundering and Terrorism Financing Prevention Act (1999) amended in December 2007, establishing measures preventing money laundering and terrorism financing. The Investment Funds Act and the Securities Market Act were last amended in March 2008, in order to harmonise them with Acquis Communautaire (i.e., the UCITS Directive 1985/611/EEC and the Takeover Bid Directive 2004/25/EC, respectively).

The securities market regulator is the Financial Supervision Authority (an agency of the Bank of Estonia), which is competent for supervision of securities market operation, investment firms, credit institutions, collective investment schemes activities, insurance and pension funds. The Financial Supervision Authority has the authority to issue advisory guidelines to securities markets legislation in order to provide guidance to subjects of financial supervision. The Tallinn Stock Exchange is the only regulated securities market in Estonia. It is part of the NASDAQ OMX Group. The NASDAQ OMX stock exchanges in Tallinn, Riga and Vilnius form the Baltic Market, sharing the same trading system and harmonising rules and market practices. In 2006, the capitalisation of the market was about 2.96 billion EUR with 15 listed companies. Clearing and settlement of securities is performed by the Estonian Central Register of Securities.

The 2007 EBRD Securities Markets Legislation Assessment (see chart below), found Estonia in "high compliance" with the Objectives and Principles of Securities Regulation published by the International Organization of Securities Commissions (IOSCO) showing only minor weaknesses.

It should be noted that while the assessment represents the legislation in force on 1 June 2007, a comprehensive set of amendments to the Securities Market Act were adopted in October 2007. The Market in Financial Instruments Directive (MiFID), the Takeover Directive and the Capital Adequacy of Investment Firms and Credit Institutions Directive were transposed into Estonian law. As a result, the securities markets framework improved further in many respects.

In order to understand how securities markets legislation works in practice, the EBRD undertook a Legal Indicator Survey in 2007 ("the LIS"). Practitioners in the region were asked to comment on a hypothetical case study, advising an investor who lost his savings after buying shares in a national company's Initial Public Offering (IPO), misled by erroneous information in the prospectus. In particular, the LIS concentrated on effectiveness of prospectus disclosure requirements, private and public enforcement mechanisms and authority of the market regulator. The LIS revealed that although IPOs in Estonia are seldom used as a source of funding, disclosure practice follows good standards. The prospectus is considered reliable and financial reporting practices are sound: EC Regulation 809/2004 directly applies detailed disclosure requirements and is well implemented. Courts and the regulator are developing good expertise in investigating complex securities cases but the corresponding capacity of prosecutor needs to be improved. Private enforcement mechanisms (i.e. legal action before a court) can be lengthy and characterised by heavy burdens of proof, which can diminish the effectiveness of the action.

Telecommunications

Institutional framework: Responsibility for regulation of the Estonian markets of communications sector was re-organised in 2008. Formerly responsibility was shared between five regulatory authorities, ENCB – the principal national regulatory authority (NRA), the Ministry of Economic Affairs and Communications, the National Competition Authority, the Consumer Protection Office and the Data Protection Inspectorate. Since 2008 it has been vested in two authorities, namely the Estonian Competition Authority (ECA) responsible for, among other topics, sector specific regulation, and the Estonian Technical Surveillance Authority responsible for spectrum, numbering and terminal issues.

Market access and authorisations: The Estonian market has been fully liberalised since January 2001 when the local, domestic, and international long-distance telephony markets were opened up to competition. Incumbent operator, Elion (previously known as Eesti Telekom), controls a majority of the fixed voice market (81 per cent in 2007), despite the market having opened up completely to competition in 2001. There were around 1.6 million mobile subscribers in Estonia in 2007, representing a teledensity rate of around 120 per cent. Competition is vigorous, with Estonian Mobile Telephone (EMT) maintaining dominance in the market (almost 50 per cent in 2007). Tele2, Radiolinja and Bravocom are the other GSM operators in the market. EMT, Bravocom, and Tele2 are also holders of 3G licences, with a fourth having been issued to ProGroup Holding in January 2007.

Competitive Safeguards: Elion has been determined to be an operator with significant market power and, as a result, the rates that it can charge for interconnection and leased lines are regulated under Long Run Average Incremental Cost methodology. The prices of mobile telephone network interconnection services in the third quarter of 2007 were among the highest in Europe, but due to regulatory intervention in the fourth quarter, upheld in court, there has been a reduction in mobile interconnection charges, specifically mobile termination rates, to close to average European indicators. Fixed telephony competition remains largely service based (Carrier

Selection/Pre-selection), with all but one alternative operator interconnecting on the national level only.

Significant Market Power: The first round of market analysis has been completed. The fact that eight out of 18 markets have been found to be fully competitive sends a positive signal as far as general market competitiveness in telecommunications is concerned. However, the remaining 10 markets will require close NRA supervision and preparedness for efficient intervention in order to prevent further market distortion.

Local Loop Unbundling: Incumbent Elion is the primary provider of local-loop access. Recent price regulation on the wholesale unbundled access market has contributed to a reduction in the incumbent's monthly rental fee for full LLU. A recently issued reference unbundling offer introduces deadlines to be respected by the SMP operator, referring to technical verification of requests for available capacities and to realisation of connections to the alternative operator. However, reports suggest that Elion's customers still appear to have preferential treatment, with connections provided in shorter deadlines.

Number portability: Number portability for fixed-line phones has been possible from 1 January 2004 and for mobile since 1 January 2005. Statistics reveal that the porting of numbers in Estonia has been rather successful in terms of numbers ported. Some 15,000 fixed telephone numbers and 39,577 mobile telephone numbers were ported in 2007 (to October), in addition to 58,578 numbers ported in 2006 and 75,443 numbers ported in 2005.

Universal service and consumer issues: Very few new fixed access lines have been granted to consumers on the basis of the universal service obligation during 2007, largely because of a high degree of fixed-to-mobile substitution in Estonia. As the affordable price is above the price of the calculated access provision cost of the designated universal service provider, there was no request for compensation of the financial burden sustained by the provision of this service during 2007.

Assessment: In a 2008 assessment of the communications sector of EBRD Countries of Operation the sector regulatory regime in Estonia was deemed to have "Full Compliance" when measured against international best practice.