Republic of Estonia
IMF Staff Visit - Concluding Statement

May 2, 2003

An IMF staff team visited Tallinn from April 28 - 2 May 2, 2003. The main objective of the visit was to meet with members of the new government and discuss recent economic developments and economic policy priorities, especially as they relate to fiscal issues and the widening current account deficit.

While economic prospects for the Estonian economy continue to be favorable, a number of risk factors are more pronounced than during the mission's last visit in August of 2002. In light of a less sanguine global environment and the continued strong growth of credit domestically, the Estonian economy has become more vulnerable. In particular, we expressed concern about the growing current account deficit. The size of the current account deficit and the composition of its financing are cause for concern, especially at a time when the country is preparing itself for ERM2 and EMU membership.

The fall in interest rates in the Euro area, lower spreads, and more aggressive lending by some commercial banks have contributed to continued strong credit growth. Through a number of measures, the Bank of Estonia and the government have wisely tried to limit this growth. However, due to the constraints of the currency board arrangement, in Estonia, potential economic imbalances have to be addressed primarily through appropriate fiscal measures.

With this in mind, we discussed with the government budget and expenditure priorities for 2003, including the supplementary budget. We were very pleased to hear that the government intends to conduct its policies in a fiscally responsible manner, as reflected by the stated objective of a balanced budget. Such an objective should, however, be viewed in conjunction with the country's position in the business cycle.

In particular, given the vulnerable external position, we urged the authorities not to spend all of the additional revenues that are expected to accumulate in 2003, but rather run a fiscal surplus at this point in the business cycle. This would both help ease pressures on the current account and send an important signal to financial markets that the new government is indeed serious about pursuing appropriately conservative financial policies. This would help ensure a smooth transition towards ERM2 and EMU membership. Accordingly, we encouraged the authorities to publicly announce a surplus target for the near term and a balanced budget over the longer term.

We discussed the spending priorities of the government for 2004 and beyond. While the government is still finalizing some of the specifics, we are supportive of the government's objective to lower income taxes. We also understand some of the other policy priorities, including the government's intention to address the low birth rate, and are sympathetic to them. We advised the government, however, to avoid hastily engaging in potentially costly fiscal measures that could lead to a loosening of the fiscal stance at this critical juncture, especially since EU related spending pressures are about to increase. Such policies should only take place when clearly identified expenditure reductions in other areas have been found. This is also important given that Estonia's level of public spending in terms of GDP is relatively high. We agreed with the authorities to continue the policy dialog during the upcoming annual Art. IV consultation mission in the second half of the July.