INTERNATIONAL MONETARY FUND CONCLUDED 2003 ARTICLE IV CONSULTATIONS WITH ESTONIA

FACT

The Executive Board of International Monetary Fund concluded the Article IV consultations with the Republic of Estonia on 22 October 2003[1].

COMMENT

PUBLIC INFORMATION NOTICE OF THE INTERNATIONAL MONETARY FUND[2]

Background

The rapid and successful transformation of Estonia into an open and flexible market economy places it as a star performer among European Union accession countries. The foundation for this accomplishment is a prudent macroeconomic policy, based on a balanced budget strategy, the currency board arrangement, and vigorous structural reform. The positive outcome of Estonia's national referendum on EU membership paves the way for EU accession on May 1, 2004, solidifying these accomplishments.

The Estonian economy continues to perform very well despite weakness in major export markets. The economy grew by 6 per cent in 2002, driven by both strong domestic investment and consumption demand, and recent data suggest that economic activity continued to be buoyant in the first half of 2003. Labour market developments were also positive with higher employment and lower unemployment. Inflation has declined to a new low, reflecting declining import prices and positive one-off factors, such as lower food prices.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarises the views of Executive Directors, and this summary is transmitted to the country's authorities.

[2] Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. See also IMF's web site at www.imf.org

Fiscal performance has been very strong, as rapid growth in domestic demand contributed to higher-than-expected tax revenue. The general government budget showed a surplus of 1.2 percent of GDP in 2002, with the positive balance continuing in early 2003 and allowing for a further build-up of deposits. This has occurred despite several supplementary budgets, a rapid increase in public expenditure, and persistent deficits at the municipal level.

A further easing of monetary conditions contributed to continued strong money and credit growth. Interest rates in Estonia declined as a result of a fall in euro-area interest rates and a decline in the country's risk premium. Furthermore, some financial institutions started to lend more aggressively to increase their market share, putting additional downward pressure on lending rates, especially in the real estate sector. Lease financing continued to grow especially rapidly. Nevertheless, Estonia's banking system remains financially very sound.

The external current account has deteriorated substantially. While large external deficits, to some extent, are a reflection of the country's growth potential, the sudden jump in the deficit from 6 per cent of GDP in 2001 to 12.3 per cent in 2002 has rendered the economy more vulnerable to external shocks. The deterioration in the current account is particularly worrisome because it was associated with a fall in foreign direct investment (FDI) coverage. Although preliminary information for the first half of 2003 suggests a renewed increase in FDI coverage, the trend of substantially higher deficits and less-than-full FDI coverage remains. Despite these adverse developments, confidence in the currency board remains strong.

Two important structural reforms have been launched: the introduction of a second pillar in the pension system, which aims at moving from the pay-as-you-go system to a fully funded defined-contribution system, and the establishment of a new unemployment insurance scheme. The introduction of the second pillar was substantially more successful than anticipated.

Executive Board Assessment

Executive Directors welcomed the results of the recent referendum to join the EU and Estonia's successful transformation into an open and flexible market economy. They hoped that the underpinnings of Estonia's success in the past, especially prudent fiscal policy and resolute focus on structural reforms, would continue to be preserved in the future. Directors considered that the overarching economic challenge in the period ahead would be ensuring lasting convergence with the EU in order to ensure a smooth transition to the euro, while maintaining a sound external position.

Directors were encouraged that, despite continued sluggish demand in Estonia's major trading partners, economic growth remains relatively strong, and the outlook positive. However, given the country's degree of openness, a prolonged slowdown in Estonia's trading partners would ultimately impact exports, consumer confidence, and investment activities. Directors also expressed concern that the large current account deficit in combination with a simultaneous fall in coverage of the deficit by foreign direct investment inflows has increased the vulnerability of the economy. While the financing of the current account deficit is unlikely to pose difficulties in the immediate future, a deficit of this size will not be sustainable over the longer term.

Directors commended the authorities for their commitment to a prudent fiscal policy, as reflected in the country's balanced budget policy. However, in light of the large current account deficit, most Directors were of the view that a more proactive fiscal policy is required to maintain macroeconomic stability. Directors recommended that the authorities target a balanced budget over the business cycle rather than on an annual basis. In this context, Directors welcomed the government's announcement that it will not pass a second supplementary budget for 2003, but they stressed that the fiscal surplus in 2003 should be higher than that achieved in 2002. They therefore recommended allowing the automatic stabilisers to operate fully and postponing some planned expenditure increases.

Directors welcomed the authorities' ambitious fiscal policy initiatives for the coming years. However, the plan to lower the income tax rate while simultaneously increasing parents' benefits could undermine the fiscal target, in particular, given that expectations for inflows of EU funds might prove to be over-optimistic. Directors cautioned that the circumvention of borrowing limits by municipalities, and the use of non-transparent fiscal transactions aimed at financing increased expenditure without affecting the publicly visible deficit, could compromise Estonia's high standards of fiscal transparency and should be resisted. To relieve budgetary pressures and to eliminate potential distortions in the financial system, consideration could be given to gradually eliminating the tax deductibility of mortgage interest payments and the tax exemption on interest income from bank deposits.

Directors noted that confidence in the country's currency board arrangement continues to be strong. They emphasised that Estonia's joining ERM II with a fixed exchange rate shortly after EU membership – as the authorities intend – will depend on continued implementation of appropriate fiscal and structural policies.

Directors welcomed the authorities' continued effort to foster the soundness of the financial sector through improved supervision, and commended their efforts to address the strong credit growth through measures such as broadening the base for reserve requirements and promoting good lending practices. However, they emphasised the need to be vigilant and to be prepared to increase prudential requirements on a temporary basis if asset prices, especially in the housing sector, increase sharply.

Directors welcomed the implementation of effective mechanisms to combat money laundering and the financing of terrorism. They noted that legislation has been amended to bring it into line with the latest EU anti-money laundering directives, and that explicit provisions criminalising the financing of terrorism are now in force.

Directors were encouraged by the recent decline in unemployment, but noted that the unemployment rate remains high, especially in the North Eastern part of the country. They encouraged the authorities to further improve labour market regulation, facilitate labour mobility, and increase investment in human capital, in terms of both general education and vocational training.

Directors commended the authorities for being at the forefront of efforts to promote data transparency and dissemination. Estonia subscribes to the Fund's Special Data Dissemination Standard and provides key data for surveillance on a timely basis.

STATEMENT BY BENNY ANDERSEN AND TANEL ROSS[3]

Estonian authorities would like to express their appreciation to Mr Haas and his team for their high quality work as well as for the excellent set of papers on a wide range of issues. The authorities broadly agree with the analysis and recommendations of the IMF staff, including on the key economic challenges in the years ahead.

Fund surveillance and advice as well as technical assistance have been invaluable for Estonia's economic transformation and during the preparations to the EU accession. Indeed, the frank, candid and transparent nature of the policy discussions on a broad range of issues illustrates the very positive role that the Fund can play in supporting the economic policymaking at every level of development. The Estonian authorities would like to take this opportunity and extend their sincerest appreciation to Mr Odling-Smee and staff of the European II Department for their dedication and assistance that Estonia has enjoyed over the past decade. They are confident that this mutual commitment and trust will continue to characterise Estonia's relations with the Fund.

With the accession to the European Union to take place in about six months, Estonia's pre-accession economic performance has remained strong. GDP growth has averaged 6.6 per cent during the last three years, reflecting a solid track record of policies geared toward the macroeconomic stability and advanced structural reforms. At the same time, these developments have been recently accompanied by a widened current account deficit, increasing the potential external vulnerability.

Recent Economic Developments and Prospects

After expanding by 6 per cent in 2002, Estonia's real GDP increased by approximately 4.4 per cent in the first half of 2003 as private consumption and investment growth moderated. The recent high-frequency indicators suggest that growth may have accelerated again in the third quarter. For 2003, real GDP growth by 4.5 per cent would be expected, somewhat below the medium term potential. For 2004, the authorities expect the economy to expand by 5.6 per cent, in line with the IMF's projection and with net exports providing a significant stimulus to growth. Inflation has remained low, increasing slightly to 1.4 per cent in September. The recent stability of the price level has been supported by the relatively large share of traded goods in the consumer basket and the stability of the utility prices. As the impact of these factors is expected to turn around next year, and with the additional effect of tax harmonisation related to EU accession, the inflation rate is expected to reach 4 per cent in 2004 and would decrease gradually to 3.2 per cent by 2006.

The fiscal performance has been broadly in line with the expectations. Public sector revenues exceeded outlays by 2.5 per cent of GDP in the first half of 2003, implying a surplus of around 0.4 per cent of GDP for the year as a whole. As in previous years, the

[3] Benny Andersen is Alternate Executive Director of the International Monetary Fund and Tanel Ross is Senior Advisor to the Executive Director of International Monetary Fund. The statement was made on October 22, 2003.

consolidated central government will record a surplus while local municipalities, most notably the capital city of Tallinn, remain in deficit by some 0.3 per cent of GDP.

For 2003, the authorities expect the current account deficit to remain broadly unchanged from 2002 at slightly above 12 per cent of GDP. The primary external deficit – defined by the authorities as the total current account deficit less dividend and interest payments on foreign direct investment, and reinvested earnings – would amount to 6 per cent of GDP. On the financing side, net foreign direct investments increased to 6 per cent of GDP in the first half of 2003.

Medium-term Adjustment of External Accounts

Estonia's competitiveness is fundamentally sound as evidenced inter alia by strong exports. Furthermore, the comparative analysis on the competitiveness in the Baltics by the IMF staff and the very recent study by Eesti Pank's economists confirm that the real exchange rate is close to its medium-term equilibrium and not overvalued. Nevertheless, the external imbalance has widened significantly. While public sector surpluses over the last years have contributed to domestic savings, the gap between private savings and investments has increased, buoyed by the relatively high credit ratings, a strong financial system, and the EU accession. The reversal of the increased external vulnerability will be of key importance to sustain high growth rates over the medium term.

The high domestic investment, reaching 34 per cent of GDP and maintained by the strong productivity performance and the continuing convergence with the European Union, is the main factor underlying the external deficit. The latest hike in investments is partly attributable to the infrastructure modernisation. The additional effect of large projects undertaken by the privatised railways and the restructured energy sector on current account deficit amounts to some 4 to 5 percentage points of GDP in 2002 and 2003. Another driving force behind the widened current account is the ongoing inter-temporal consumption adjustment, sustained by increasing real incomes and efficient financial intermediation. Financial leverage of private persons is still relatively low with their total debt burden standing at 18 per cent of GDP. Furthermore, the relatively modest growth in Estonia's main export markets has had its impact on the external accounts until recently.

The major one-off effect of these special factors is expected to be gradually shaved off. Indeed, the authorities consider that the adjustment has already started in the middle of this year. For 2004, the current account deficit is expected to diminish to 10 per cent of GDP (6 per cent of GDP for the primary external balance) and to decrease further to 9 per cent of GDP by 2006. Estonian gross external debt would stay at around 70 per cent of GDP in 2004 and remain broadly unchanged or even decrease gradually thereafter. The net indebtedness, equal to 11 per cent of GDP as of 2003, would remain much lower.

On the financing side, capital inflows are expected to remain strong. Foreign direct investments would return to a comfortable level of around 5 per cent of GDP, after the temporary decline due to the increased infrastructure-related borrowing in 2002. This projection does not appear to be overly optimistic as the share of foreign direct investments to purchasing-power-parity adjusted GDP is lower in Estonia than in a number of small EU Member States. Nevertheless, the Estonian authorities expect the relative importance of other inflows to increase, as Estonia's economy and financial system will integrate even further to the EU single market. The very limited direct impact of the so-called convergence play on Estonia's financial markets provides further support to external resilience. The credibility of the currency board and the structure of the financial system have facilitated the convergence of nominal interest rates towards the euro rates for some years already, and the capital inflows have focused mostly on longer term investment opportunities.

Macroeconomic Policies in 2004

The overarching macroeconomic objective of the Estonian authorities is to ensure lasting convergence with the European Union and the euro area, resulting in the Maastricht criteria to be met in a sustainable manner. In the near term, the increasing external vulnerability is the most important concern. To address these challenges, the policy framework as provided by the authorities in their recent Pre-Accession Economic Program, will be centred around the fixed exchange rate and currency board, and supported by prudent financial sector policies. On the fiscal front, the authorities are fully committed to budgetary balance over the business cycle, consistent with the provisions of the Stability and Growth Pact. Consequently, public debt is expected to remain below 6 per cent of GDP and the government will retain its net creditor status vis-à-vis the rest of the world. Within this framework, the authorities intend to allow the automatic stabilisers to function to the fullest extent possible.

Monetary and Financial Sector Policies

The Estonian government and the central bank intend to seek participation in ERM II immediately after joining the EU, in accordance with all relevant multilateral procedures and within the established framework. Consistent with the provisions of the EU Treaty, the authorities plan to adopt the euro at the earliest possible date thereafter. Estonia intends to maintain the currency board as a unilateral commitment during the ERM II membership.

As private credit growth increased in 2002, the authorities took a number of measures to limit its macroeconomic and prudential impact. Government deposits were transferred out from the domestic financial system last year, and the ratio of mandatory liquidity requirements for banks was effectively increased. The authorities have also discussed the possible use of prudential ratios for counter-cyclical purposes. Until now, they have decided to refrain from taking additional actions, not least because Estonia's financial system is fully integrated into large regional financial conglomerates. It is likely that this market structure would render the efficient use of the discretionary policy measures increasingly difficult and may entail unwelcome distortions. However, the authorities will continue to monitor closely the consolidated financial system, and they are ready to act, should the gradual decline of credit growth be reversed. Additionally, in line with the recommendations of the IMF staff, the government has prepared the amendments to the tax legislation that would reduce the maximum amount of tax deductibility of interest payments on mortgage loans.

On the supervisory front, the authorities issued a number of recommendations to commercial banks in December 2002, to ensure strict adherence to good lending practices, the adequate collateralisation of bank credit, and importance of banks' internal stress testing exercises. The follow-up assessment of the efficiency of this step was accomplished in the second quarter of 2003 with the reassuring conclusion that banks have reviewed their internal lending procedures in line with the recommendations. The supervision has also stepped up on-site inspections and analysis of banking groups, including the non-bank affiliates. The ability to take further corrective measures is enhanced by the close cooperation among the central banks and supervisors in the Baltic and Nordic region, based inter alia on memoranda of understanding.

Fiscal Policy

Estonia has pursued a conservative fiscal policy, consistent with the fixed exchange rate regime and fully in line with the EU framework. With a low single digit public debt and small overall surplus in recent years, a joint study by the Ministry of Finance and Eesti Pank also reveals that the structural position of the general government actually strengthened between 2000 and 2002. The authorities expect the general government surplus for 2003 to reach 0.4 per cent of GDP. While they admit that even higher surplus may have been justified, as proposed by the IMF staff, the increase in investment expenditures was necessary to complete a number of investment projects, partly related to the EU accession. After enacting these additional expenditures in the supplementary budget in June 2003, the authorities have declared that no more additional budgets will be introduced this year. While some additional investments were recorded as a capital injection to the government's real estate management company, both the government and the central bank publicly regard this transaction as net financing for the purposes of economic analysis.

A state budget for 2004, fully balanced on the general government level, was submitted to parliament in mid-September and is expected to be approved before the end of the year. As indicated in the IMF report, the Estonian government has launched a number of structural fiscal policy measures for 2004 and beyond, aiming inter alia at lowering the direct income taxation and addressing some key social policy concerns. While the authorities consider these steps of being very important for the medium- and long-term development, they stand ready to take balancing fiscal measures if needed. It should be noted that most of the co-financing requirements related to the EU funds is accommodated in the current public investment portfolio. Moreover, when assessing the policy stance, the relatively limited contingent pension liabilities should be taken into account.

While the Estonian constitution provides local governments with significant autonomy, the authorities are monitoring the fiscal situation in municipalities very closely. They concur with the IMF that local fiscal management should be strengthened. As a number of local governments are about to reach their borrowing limits in the near future, the consolidation of finances at the local level is already underway. Additionally, some large municipalities, most notably Tallinn, have announced plans to target explicit medium-term budget balance from now on. And last but not least, the fiscal strength of local governments will eventually have impact on their credit ratings and, consequently, on the cost and availability of their financing. The government is also stepping up its efforts to encourage voluntary mergers of the municipalities.

Structural Policies

As emphasised by the IMF, the Estonian structural reform agenda is largely driven by the EU integration process. The authorities continue to promote advanced structural reforms to maintain Estonia's strong competitive position, and have drawn up a long-term road map "Estonia 2014" in line with the goals of the Lisbon process. Key objectives in this regard are the sustainability of the pension and health care systems, increasing labour supply and market efficiency, and the promotion of an efficient business environment.

The completion of the pension reform reduces substantially the contingent liabilities of the state budget. Indeed, as noted by the IMF staff, the pension reform has been rather successful and over one third of the working-age population has joined the fully funded second pillar after its launch in May 2002. In addition, the government is implementing the structural health care reform within the framework of the current solidarity-based insurance system. While the present system is financially stable and does not take recourse to state budget, further reforms are needed to ensure the sustainability of health care expenditures that are expected to rise over the medium term from the current 5 per cent of GDP.

Estonia's enterprise restructuring and privatisation is virtually accomplished. A small number of large infrastructure enterprises remains in state ownership for the time being. These include the state energy company as its privatisation failed in 2002 due to the financial difficulties of the prospective buyer, the post office and Port of Tallinn. In addition, the government's real estate assets are managed by a separate state-owned firm, incorporated under the business legislation. All these entities are profitable and managed in accordance with sound and transparent corporate governance rules. The government is contemplating the divestiture of its non-strategic portfolio in accordance with the market conditions. The main focus of Estonia's industrial policy is now on supporting research, technology development and innovation, mostly by improving access to start-up capital and fostering training programmes in line with the EU policies. The full liberalisation of the energy market for enterprises will be completed by 2012, in line with the outcome of the EU accession negotiations.

While unemployment has been gradually declining, the Estonian authorities agree with the IMF staff that more needs to be done to improve the functioning of the labour market. In that regard, the Selected Issues paper provides some insightful findings that, we believe, should be elaborated even further. In general, the authorities believe that the market structure is still flexible enough to facilitate the increase of employment in the future, and the income tax reform would lower the effective level of the labour taxation. In line with the Employment Action Plan for 2003, the government is pursuing a number of active labour market policy measures, and is supporting the regions that are severely hit due to industrial restructuring. In particular, the respective governmental agencies are implementing two complementary sub-programmes to foster SME development and to improve labour market conditions in North-Eastern Estonia.