November 2006
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Republic of Estonia: 2006 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Estonia

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2006 Article IV consultation with the Republic of Estonia, the following documents have been released and are included in this package:

- the staff report for the 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on August 25, 2006, with the officials of the Republic of Estonia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on November 1, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF;

- a staff statement of November 17, 2006 updating information on recent developments;

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its November 17, 2006 discussion of the staff report that concluded the Article IV consultation; and

- statement by the Executive Director for the Republic of Estonia.

The document listed below has been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF ESTONIA

Staff Report for the 2006 Article IV Consultation

Prepared by Staff Representatives for the 2006 Consultation with the Republic of Estonia

Approved by Alessandro Leipold and G. Russell Kincaid

November 1, 2006

Executive Summary

Background: After several years of rapid growth the economy is now hitting capacity constraints. Low interest rates, rising confidence in the wake of EU accession, and robust external demand have lifted GDP growth above 10 percent. To date, growth has been supported by productivity increases (maintaining competitiveness) and by a surge in employment (bringing unemployment to a record low). But there is clear evidence of overheating: rising core inflation, a wide external current account deficit and rapid, largely foreign-funded, credit growth. Rising incomes and cheap credit have also fueled a real estate boom. Inflation, though not high for a converging economy, exceeds the Maastricht reference value, delaying euro adoption.

Outlook: Growth is projected to ease in 2007–08 as capacity constraints bite and as rising interest rates and private sector debt contain domestic demand. If demand does not slow as expected, however, continued rapid credit growth and a widening current account deficit could increase the risk of a hard landing. In any case, overheating pressures and convergence effects will make it difficult to meet the Maastricht inflation criterion in the next two years.

The overheating calls for a tight fiscal stance but the authorities found this to be difficult in light of the existing surplus, the stepping-up of EU-supported spending, and the political calendar. Nonetheless the current procyclical stance is inappropriate and raises, rather than lowers, macroeconomic risks. The budget framework should also be strengthened.

Rapid credit growth has financed high rates of investment but its pace has also created large potential risks. Estonia's regional financial integration limits the authorities' ability to influence banks' risk management or the pace of credit growth. This puts a premium on supervisory vigilance and close cooperation with supervisors in Nordic countries.

Euro adoption remains a key objective but the authorities have limited tools to reduce inflation below the Maastricht threshold. The best approach would be to use restrictive fiscal policy and the timing of excise increases to position the economy for euro entry when exogenous price developments turn favorable. The risks from some delay should be small given the robust currency board arrangement, but an open-ended delay should be avoided.

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I. BACKGROUND

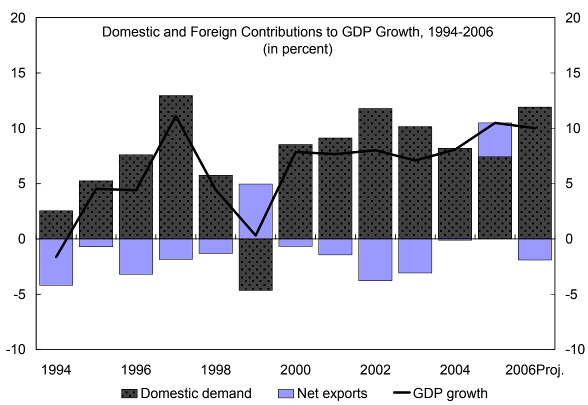
1. **Estonia's commitment to free markets and prudent financial policies has paid off handsomely.** Far-reaching structural reforms created a well-functioning market economy, well integrated with the Baltic and EU regions. Labor and product markets are flexible; the banking sector is almost entirely in the hands of reputable regional banking groups; and the business climate is among the most highly rated in the region. Prudent macroeconomic policies, broadly consistent with IMF advice (Box 1), have brought price stability and low public debt. These policies have borne fruit with impressive productivity growth and a corresponding rise in per capita income (Figure 1). The task facing the authorities now—and the challenge facing the government to be formed after the March 2007 parliamentary elections—is to sustain this performance while addressing the overheating risks associated with full employment.

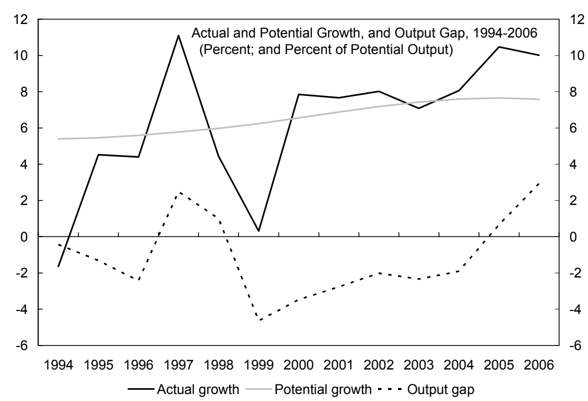
Box 1. Article IV Fund Policy Advice Implementation

Estonia has had an excellent working relationship with the IMF since becoming a member in May 1992.[1] Most Fund policy advice has been taken on board and its implementation has been characterized by a high degree of ownership, which has proven to be key to Estonia's economic success. In recent years, however, Estonia's fiscal policy has been more expansionary than advised by the Fund.

1/ For a detailed discussion of the history of Estonia's relations with the IMF, see "IMF and the Baltics: A Decade of Cooperation," by Adalbert Knoebl and Richard Haas, IMF WP/03/241.

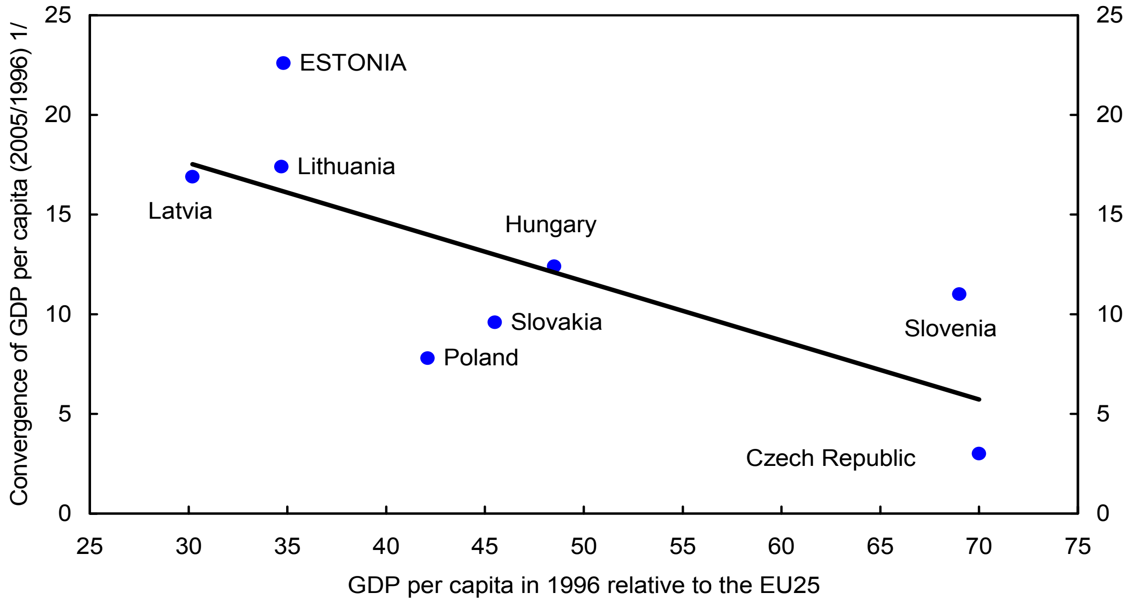
2. **GDP growth rose above 10 percent in 2005 amid signs of overheating and is expected to continue at about the same rate—above estimated potential—in 2006** (Table 1).[1] Strong exports were the motor of the 2005 acceleration while consumption lagged behind income. In the first half of 2006 the demand mix reversed: consumption growth

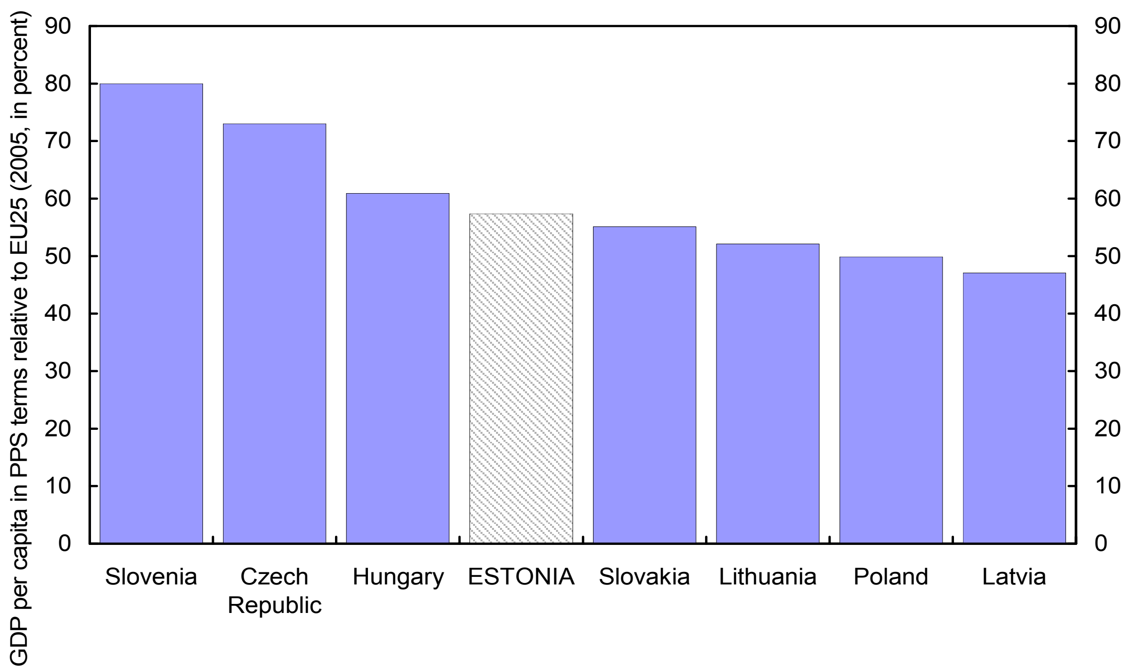




[1] This report uses revised national income and product data (covering 2000–06) released by the authorities in September 2006.

Figure 1. EU8 Member States: Progress in Income Convergence to EU25 Average, 1996–2005
(GDP per capita in Purchasing Power Standards (PPS))

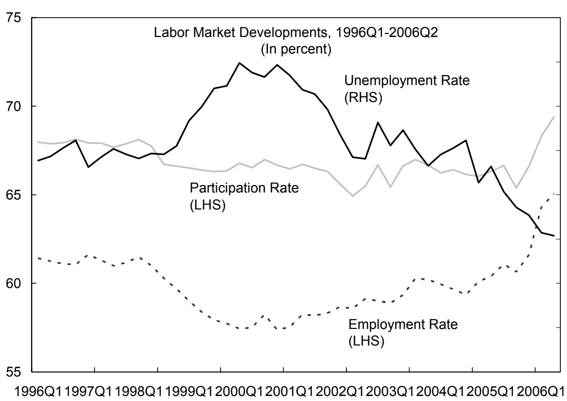


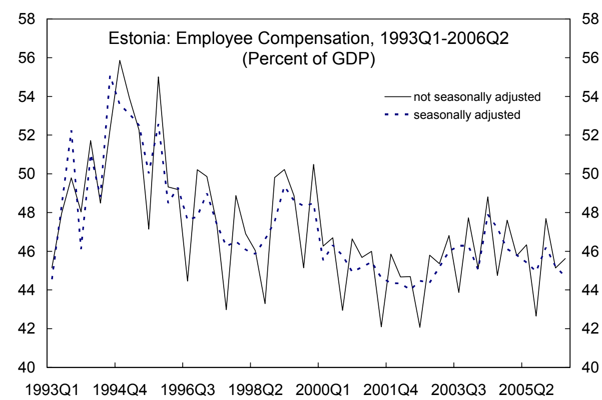


Sources: Eurostat; and staff calculations.
1/ Change in the ratio of per capita GDP to that in the EU.

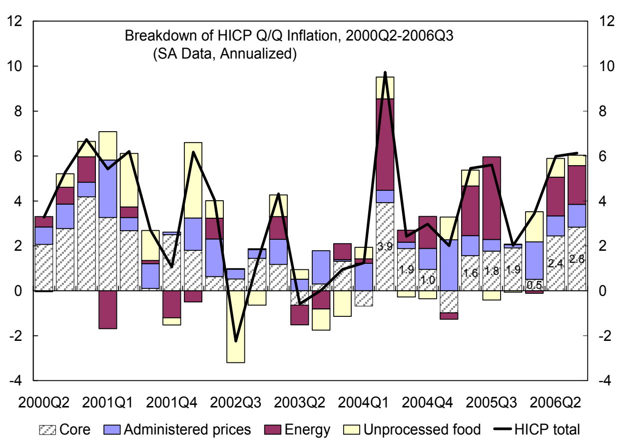
gathered pace, responding to income growth and record-high consumer confidence following EU accession, but net exports declined as surging imports overwhelmed still-strong export growth. Staff calculations suggest that the economy is operating well above potential, an assessment borne out by tight labor markets and rising inflation in nontradeables.

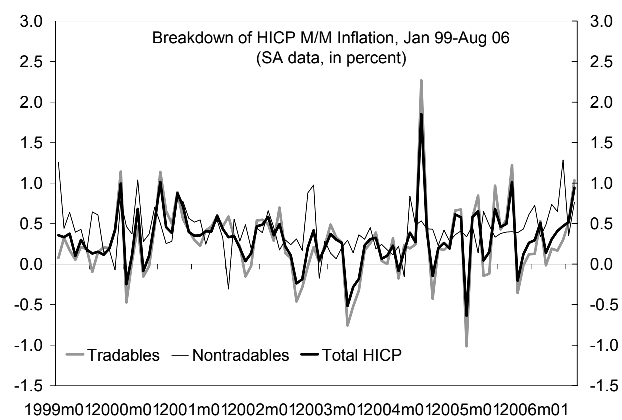
3. **Demand pressures and rapid productivity growth have produced strong wage increases and large employment gains**. The unemployment rate, which had been stuck at about 10 percent for two years, fell below 8 percent in 2005 and labor shortages emerged in a number of sectors, notably construction and health care. Labor markets tightened further in 2006, when strong employment demand was filled largely by retirees and discouraged workers drawn back into the labor force by higher wages. The competition for labor, and the upward pressure on wages, has been intensified by expanded job opportunities in other EU economies. Labor's share in value added eased in the past two years, however, suggesting that productivity has kept pace with real wages.





4. **Inflation, while moderate for a fast-converging economy, remains above the Maastricht threshold, and has been pushed up in recent months by rises in non-traded goods prices.** Given the euro peg, convergence effects normally keep Estonia's inflation rate





above the euro area average. The economy's high energy intensity exposes it to oil and fuel price increases, which gave a further impulse to inflation in the last year. That impulse is now waning, but is being replaced by rising nontradables inflation—a symptom of overheating. Average annual inflation therefore remained between 4 and 4½ percent in 2006 prompting the authorities to postpone their target date for euro adoption from 2007 (the date planned upon joining ERM II).

5. **Estonia's economic growth has supported—and been supported by—rapid credit growth, financed increasingly by resource transfers from Nordic banking groups to Estonian affiliates.** Banks' intense competition for market share has driven nominal interest rates to levels similar to those in Nordic markets. The low interest rates—negative in real terms—and exuberant expectations have raised bank credit growth to the nonfinancial private sector above 60 percent per year (Figure 2). The bulk of the new lending was linked to the real estate sector where it contributed to rapid price increases, especially in late 2005. Nonetheless, the stock of private sector credit remains well below euro area averages (Figure 3). Recent developments, including rising euro interest rates, a possible pause in the property boom, and rising debt burdens are likely to slow credit growth from its current torrid pace. Nonetheless, credit can be expected to grow robustly over the medium term as financial deepening and convergence continue (Box 2).

Box 2. Financial Deepening and Real Convergence

Financial deepening in Estonia over the last decade was associated with significant real convergence in living standards to the European Union average–indeed, Estonia has achieved more real convergence than other new member states for a given amount of financial deepening. As convergence proceeds, bank credit is likely to continue growing rapidly, particularly given the limited development of other financial markets in Estonia. Demand for residential mortgages in particular could remain strong since dwelling sizes and the quality of the housing stock are well below European averages, pointing to an unfilled demand for new or refurbished housing.

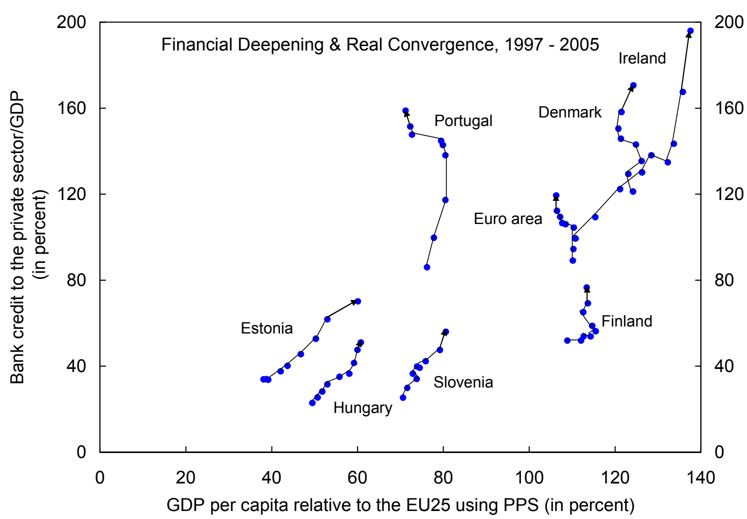
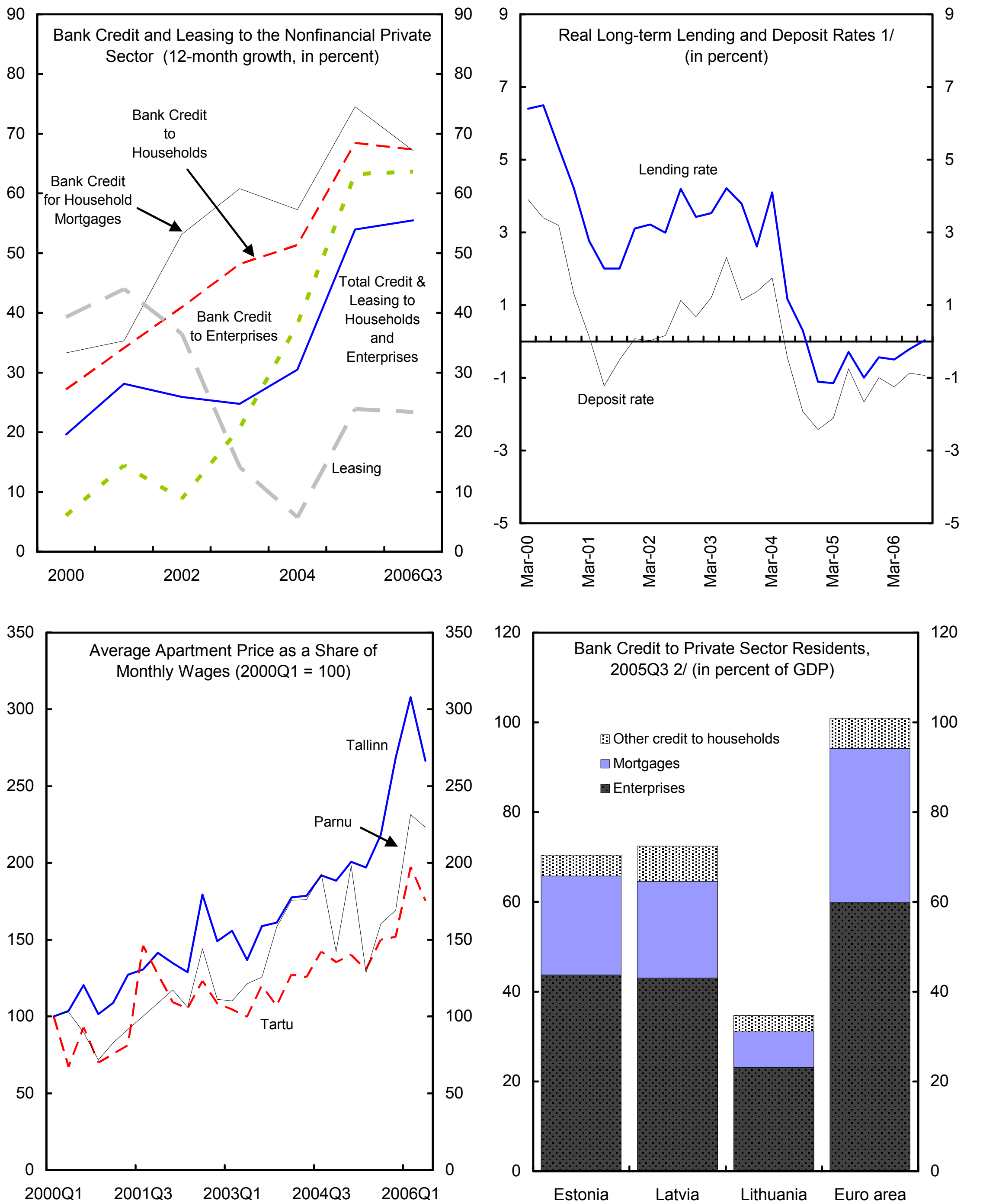
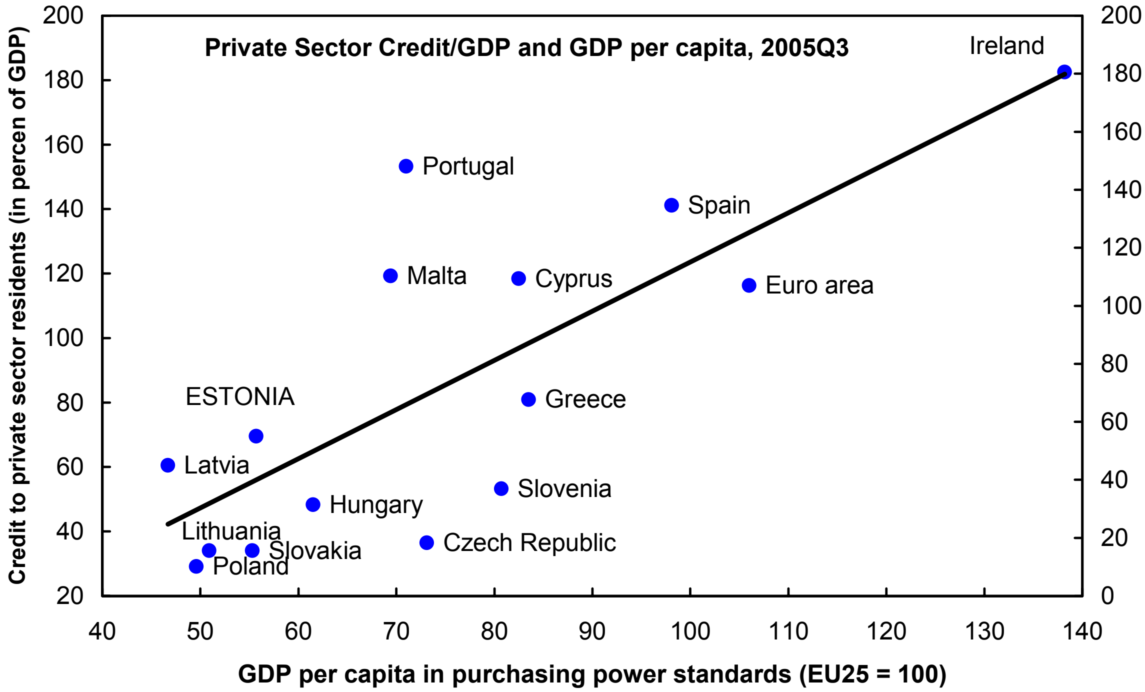


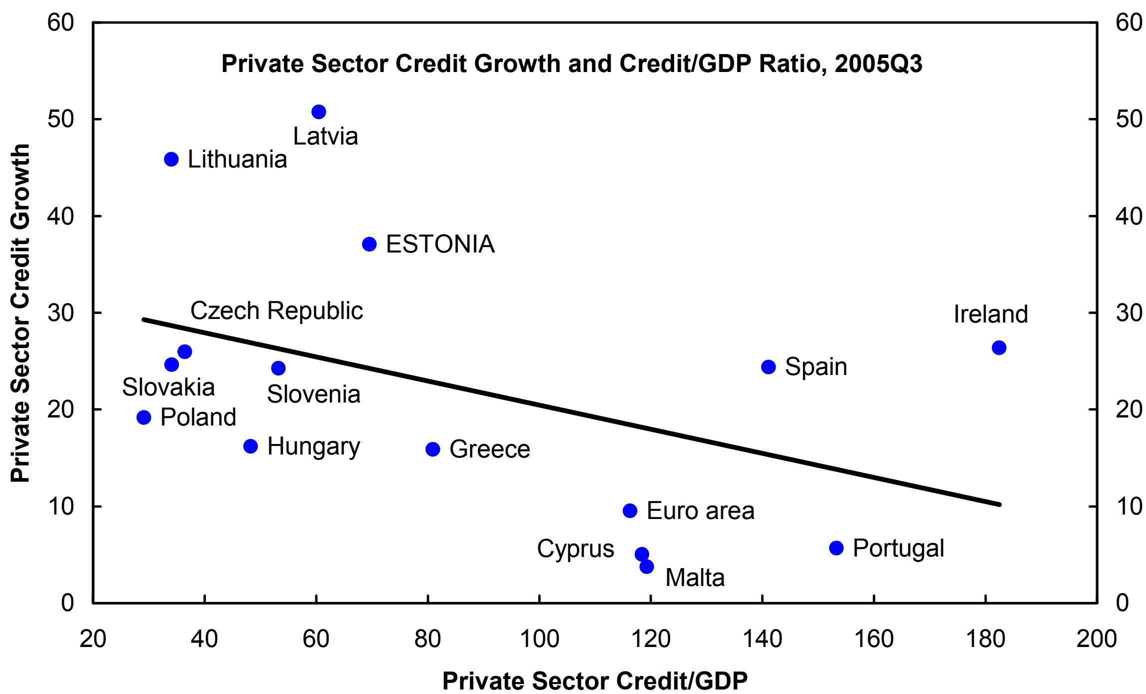
Figure 2. Estonia: Credit, Interest Rates, and Property Price Developments, 2000–06



Sources: Bank of Estonia; Estonian Statistical Office; Bank of Latvia; and Fund staff calculations.
1/ 10+ year euro denominated loan, 1+ year kroon denominated time deposit, both adjusted by the official CPI inflation.
2/ For Latvia, the latest observation is 2006 Q1.

Figure 3. Estonia: Credit Developments in Estonia and Selected EU Economies, 2005

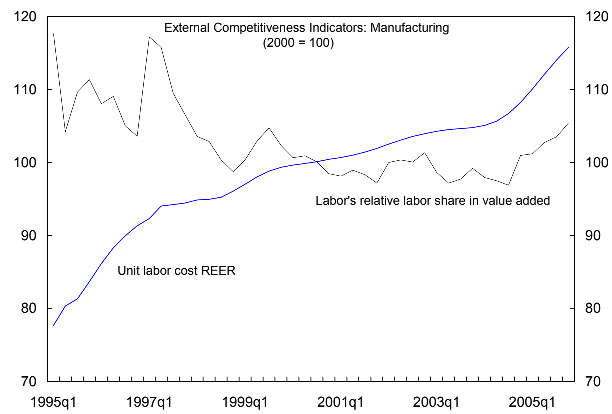




Sources: Eurostat; and staff calculations.

6. **Foreign-funded credit growth and foreign direct investment have been the counterparts of large current account deficits.** Foreign savings, recently in the range of 10-12 percent of GDP, have supported high rates of investment and some consumption smoothing. External liabilities have risen accordingly: Estonia's negative net external investment position now equals annual output, although three-quarters of this is equity stemming from foreign direct investment. In recent years gross external debt has also risen significantly and now stands at 85 percent of GDP, most of it owed by banks to their parent groups (Tables 3 and 5). Net debt stands at almost 30 percent of GDP (Figure 4).

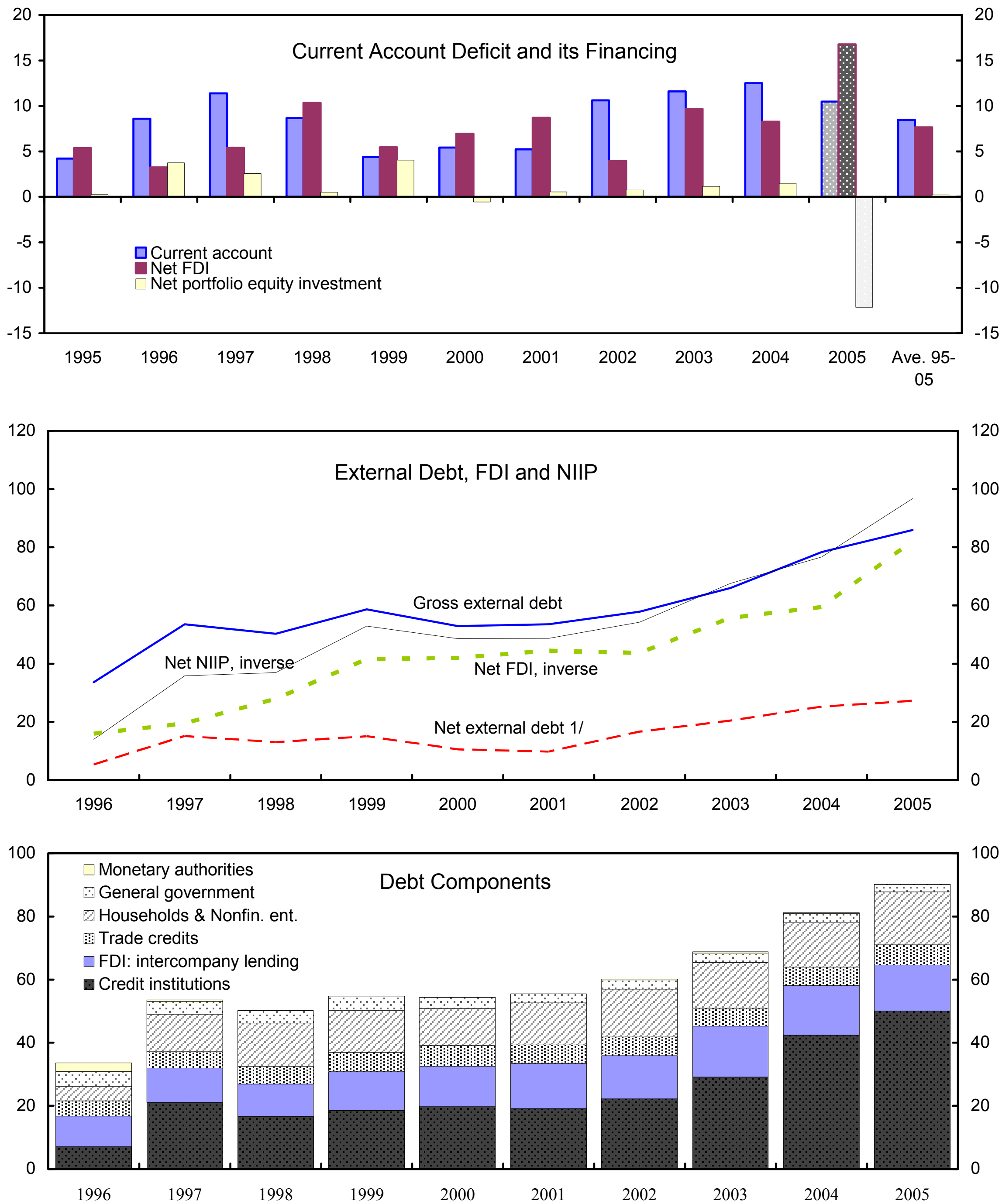
7. **External competitiveness appears adequate although recent trends call for close monitoring**. Overall, the share of industry in total output has increased, suggesting that high profitability is drawing resources into the tradeables sector. Indeed, export volume growth accelerated to nearly 20 percent in 2004–05, bringing further increases in Estonia's world market share (Figure 5). While price-based and unit labor cost-based real effective exchange rates show trend appreciations, this coincides with a shift in composition to higher-value added exports (Figure 6). Although labor's share of overall income—which is inversely related to profitability—has been broadly stable during the last five years, it has risen during the last year relative to partner countries, suggesting that the competitive environment is becoming more demanding. Moreover, the pace of technological upgrading in Estonia may have slowed in recent years.[2]



8. **The general government balance is expected to show a sixth consecutive surplus in 2006.** Despite an initially balanced budget for 2006, staff projects a surplus of nearly 2 percent of GDP. This better-than-expected outturn is the net effect of higher-than-budgeted revenues (a more than 3 percent of GDP overperformance, reflecting buoyant economic activity and improved tax compliance) and a supplementary budget that allows much of the unbudgeted revenue to be spent. In September, the government approved a draft supplementary 2006 budget with a 1.2 percent of GDP surplus and a draft 2007 budget with a surplus equivalent to 0.8 percent of staff-projected GDP.

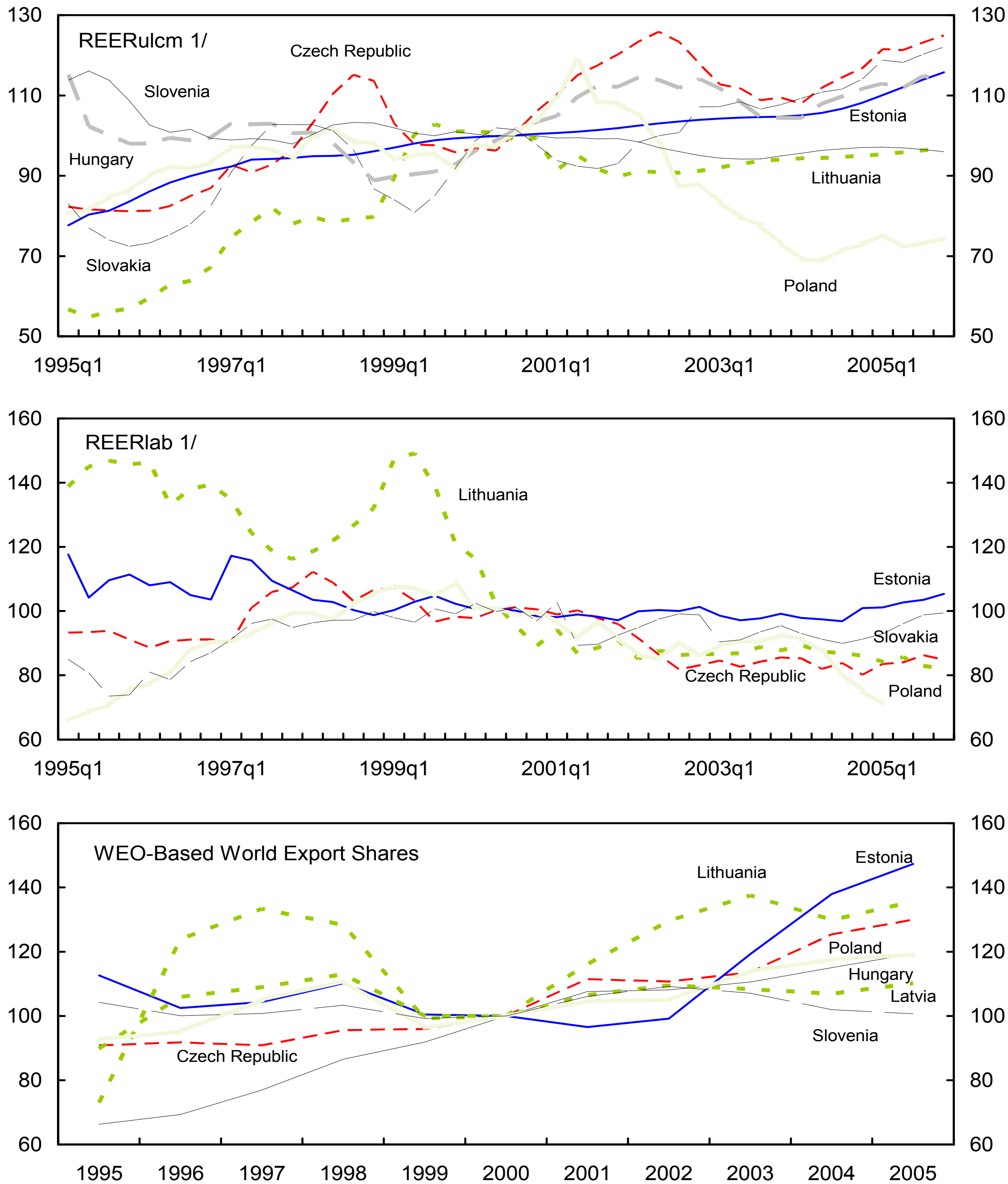
[2] Estonia's competitiveness is examined further in an accompanying selected issues paper.

Figure 4. Estonia: Current Account, FDI, and External Debt, 1995–2005
(In percent of GDP)



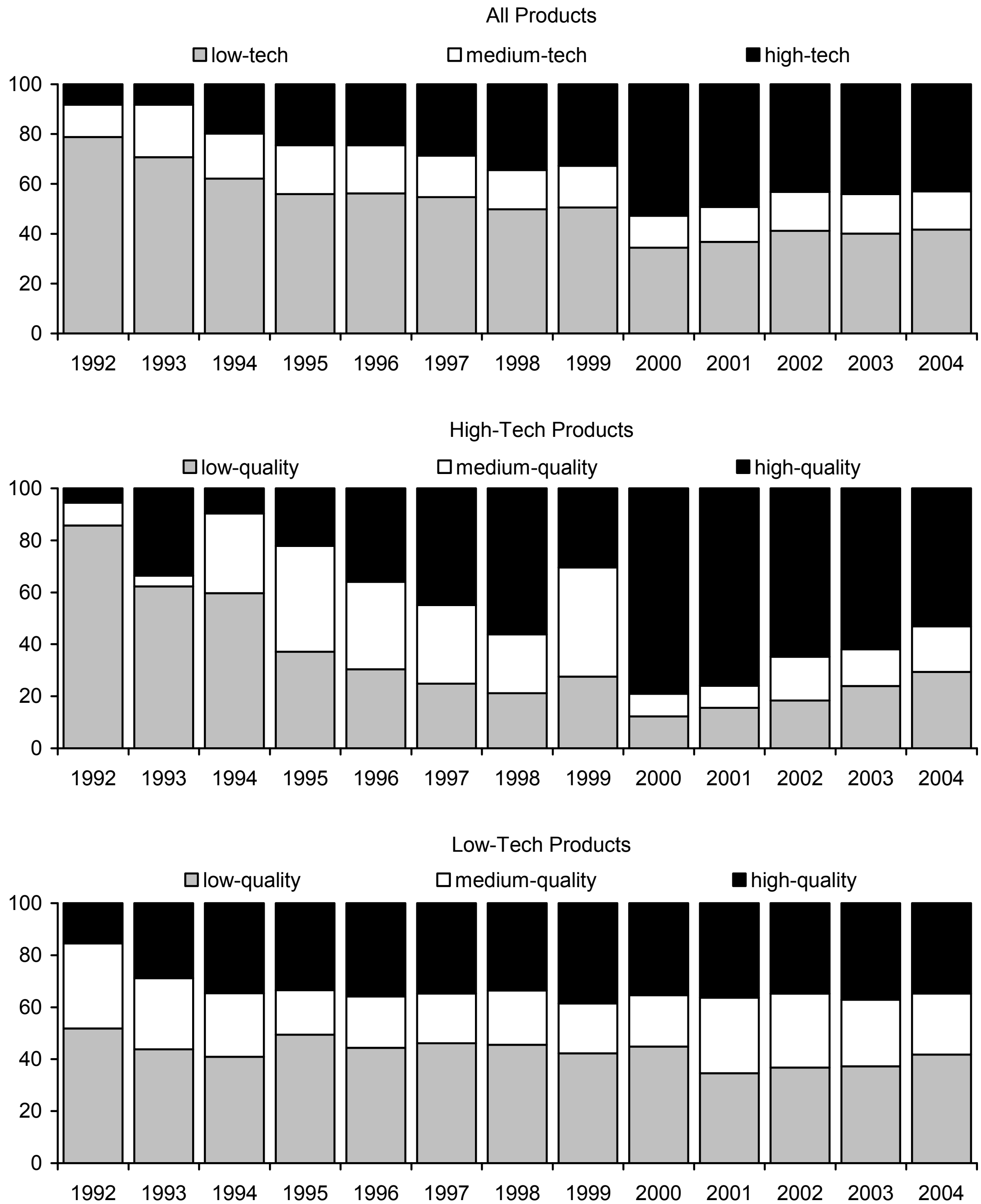
Source: Bank of Estonia.
1/ Net of portfolio, financial derivatives, other investment, and reserve assets held by the Bank of Estonia.

Figure 5. New EU8 Member States: Real Effective Exchange Rates and World Trade Shares, 1995–2005
(2000=100)



Sources: EC; WEO; and staff caculations.
1/ REERulcm is the real effective exchange rate based on unit labor costs in manufacturing. REERlab is the REERulcm divided by an REER based on industry deflators, and corresponds to labor's income share in manufacturing relative to those in trading partners.

Figure 6. Estonia: Export Composition by Technology and Quality, 1992–2004



Source: Fabrizio, Igan, and Mody (2006).

Note: Low technology industries include food products, beverages and tobacco, textiles, leather, wood and paper products, and basic metals. Medium technology industries are chemicals, plastics, and rubber. High technology industries comprised machinery, electrical and optical equiment, and transport equipment. Each insdustry is divided into three quality segments by ranging the products according to their unit values.

II. Discussions with the Authorities

A. Macroeconomic Outlook and Risks

9. **The authorities and staff anticipate that growth, inflation and external imbalances will moderate in 2007–08 as demand pressures ease.** Rising interest rates and the increasing private sector debt burden should slow domestic demand growth. Export growth should also decline given weakening demand by trading partners but, with imports slowing even more, the external current account deficit would narrow. Continuing productivity growth and the flexible labor market should ease the adjustment to slower growth. Inflation should slow in 2007–08 on account of lower fuel prices but could remain above the Maastricht reference criterion, jeopardizing the timetable for euro adoption. Looking forward, with the attainment of full employment and greater possibilities for emigration, growth in the medium term could become increasingly constrained by the scarcity of labor (Table 4).

GDP Growth, 2001-2007

	2001	2002	2003	2004	2005	2006 Proj.	2007 Proj.
	(percent change)						
Real GDP	7.7	8.0	7.1	8.1	10.5	10.0	8.4
Private consumption 1/	7.4	11.2	6.9	6.9	8.2	13.9	9.9
Public consumption	2.6	1.9	0.3	2.2	1.1	3.0	3.0
Gross fixed capital formation	9.7	24.1	7.0	13.5	12.7	12.0	7.0
Exports	2.0	1.7	7.6	17.1	21.5	16.1	10.5
Imports	3.5	6.0	10.6	15.2	15.9	17.1	9.8
Net exports 2/	-1.5	-3.8	-3.1	-0.1	3.1	-1.9	0.0

1/ Includes nonprofit institutions serving households.
2/ Contribution to growth.

10. **This outlook is subject to risks whose avoidance was the focus of the discussions.** A main risk is that demand does not ease as expected. Overly optimistic expectations could lead to continued consumption growth, reignite the real estate market, extend the credit boom, and slow the decline in the current account deficit. Further increases in the prices of nontradables would draw resources from the tradeables sector, and keep inflation high, extending the delay in euro adoption. Meanwhile, growing labor shortages could push wage growth above productivity gains, undermining competitiveness. In sum, the vulnerabilities embedded in households' balance-sheets would deepen, exposing the economy to shocks such as a correction in real estate prices or a deterioration in the external environment. Staff and the authorities agreed to focus the present consultation on policy measures to mitigate these risks, and to take up medium-term challenges with the 2007 consultation. Accordingly, discussions focused on overheating, euro adoption and credit growth.

B. Policy Responses to Overheating

11. **The authorities agreed that fiscal tightening was the only available macroeconomic instrument to address overheating but felt that the scope for further tightening—and also the payoff—was limited.** The scope was limited by the fact that the fiscal position was already very strong compared, for example, with other EU countries. Indeed gross *debt* would, in 2007, fall below the Maastricht *deficit* ceiling. Moreover, the authorities had already created a fiscal cushion—there was a comfortable stabilization fund and Pillar I pensions had been prefunded through 2010 at least. As for the payoff, they noted

that, given the openness of the economy, the fiscal stance would have only a small impact on aggregate demand or inflation. Thus, while the authorities did plan to resist pressure for excessive spending, they found it difficult to justify large surpluses—particularly in an election year. They nonetheless undertook to seek ways to limit fiscal pressure on domestic resources. Staff suggested that expenditures with high import content could be favored, while expenditures falling on sectors where overheating pressures were greatest, such as construction, could be candidates for postponement.

12. **The staff welcomed the effort to resist election year spending pressures but emphasized that the proposed budgets were expansionary.** The proposed supplementary 2006 budget would spend much of the revenue overperformance while the draft 2007 budget would allow spending to rise much faster than potential GDP (text table). These expenditures would override the fiscal automatic stabilizers and would be hard to reverse in the future, when aging-related expenditure pressures start to build. Staff also pointed out that increased expenditures financed by EU grants delivered fiscal stimulus even though they did not increase the measured deficit. The timing is unfortunate since the spending is coming on stream just when a fiscal withdrawal was needed. The planned 1 percentage point per year cut in income tax rates during 2007–09 would also come at an inopportune time.

Estonia: Selected Fiscal Indicators
In percent of GDP

	2004	2005	2006 Proj.	2007 Proj.
General government balance	1.6	1.6	1.9	0.9
Structural balance	2.3	1.4	1.0	-0.4
Transfers from the EU 1/	2.0	2.0	2.7	3.9
Transfers to the EU (contribution to the EU budget)	0.6	1.0	0.9	0.9
Adjusted structural balance (excludes net EU transfers)	0.9	0.4	-0.9	-3.4
Fiscal impulse 2/	0.9	0.5	1.2	2.5
Memorandum item:				
Output gap	-1.9	0.7	2.9	3.9

Source: Data provided by the Estonian authorities and Fund staff projections.

1/ Virtually all EU funds in Estonia are channelled through the budget.
2/ First difference in the adjusted structural balance, with sign reversed.

13. **The authorities emphasized that rising EU-funded expenditures made it difficult to impart a contractionary fiscal impulse.** "Sterilizing" the expansionary impact of EU-related spending by cutting expenditures elsewhere would be unacceptable to the Estonian public. Postponing EU-funded projects was also problematic: given the deadlines for using EU funds, there was no guarantee that expenditures could be postponed long enough to situate them at a more appropriate phase of the cycle. Moreover, much of the expenditure was on infrastructure needed to secure long-term growth.

14. **With labor shortages pushing wages up across a wide range of skills, staff suggested that consideration be given to easing restrictions on importing labor.** The authorities noted that Estonia had no restrictions on inflows of labor from European Union members, but they were concerned that using low-cost labor from other countries could prolong Estonia's reliance on declining low-wage sectors. They felt it would be better to encourage a shift to more high-technology, high-value-added sectors such as communications or information technology, and accordingly planned to ease restrictions for skilled labor. The authorities were also concerned about the political and social implications

of large-scale immigration. The staff nonetheless suggested that, to help address overheating, restrictions could be eased so as to allow a broader spectrum of workers to enter cyclically tight sectors.

15. **The mission also reviewed preparations for a medium-term budgetary framework (MTBF)** (Box 3). Staff welcomed the progress so far in implementing the framework, which builds upon FAD technical assistance. A MTBF would provide better control over aggregate spending, subject spending programs to improved review and costing, and improve allocation by linking strategic planning to the budget.

Box 3: Estonia's MTBF

The Ministry of Finance produces a State Budget Strategy (SBS) for government approval every year. The SBS sets out a macroeconomic and fiscal framework, including expenditure priorities and ministry-level expenditure ceilings, for the budget year and three subsequent years. It was strengthened in 2006 by introducing a new strategic planning system and program classification of expenditures. Staff views the SBS as a sound basis for an MTBF and made recommendations on coverage, improving out-year estimates, simplifying strategic planning, and strengthening the role of the MTBF in the policy debate.

C. Euro Adoption

16. **The authorities continue to view euro adoption as a key policy priority.** In their view, shared by the staff, euro adoption would lock in the benefits from the currency board arrangement (CBA) (financial and economic integration with the EU, and a stable and predictable policy framework) and remove the residual risks, however small, associated with having a separate currency. They emphasized that the fourteen-year track record of growth and financial probity under the strictures of the CBA, including the bounce-back after the 1998 Russia crisis, was evidence of the flexibility in labor and product markets needed to thrive under a common currency. And they were confident that competitiveness remained adequate.

17. **On timing, the authorities did not see a two or three-year delay as problematic.** In their view, the political commitment to fiscal balance or surpluses and market confidence in the kroon both assure the viability of the very robust currency board arrangement. This view is shared by market institutions, at least for modest delays. Indeed, in July, when rating agencies downgraded the outlook on Estonia's 'A' long-term sovereign rating from positive to stable (citing a likely two-year delay in euro adoption) money

Estonia: Nominal Convergence, 2005

	Deficit	Debt	Inflation	Interest rate 1/
	(In percent of GDP)		(In percent)	
Estonia	**1.6**	**4.8**	**4.1**	**4.0**
New EU8 member countries 2/	-2.5	32.2	3.2	4.3
Czech Republic	-2.6	30.5	1.6	3.5
Hungary	-6.1	58.4	3.5	6.6
Latvia	0.2	11.9	6.9	3.9
Lithuania	-0.5	18.7	2.7	3.7
Poland 3/	-2.5	42.5	2.2	5.2
Slovak Republic	-2.9	34.5	2.8	3.5
Slovenia	-3.3	29.1	2.5	3.8
Memorandum Items:				
Maastricht Convergence criteria, 2005	-3.0	60.0	2.5	5.4
EU25	-2.3	63.4	2.2	3.7

Sources: Eurostat, IFS, and country authorities.

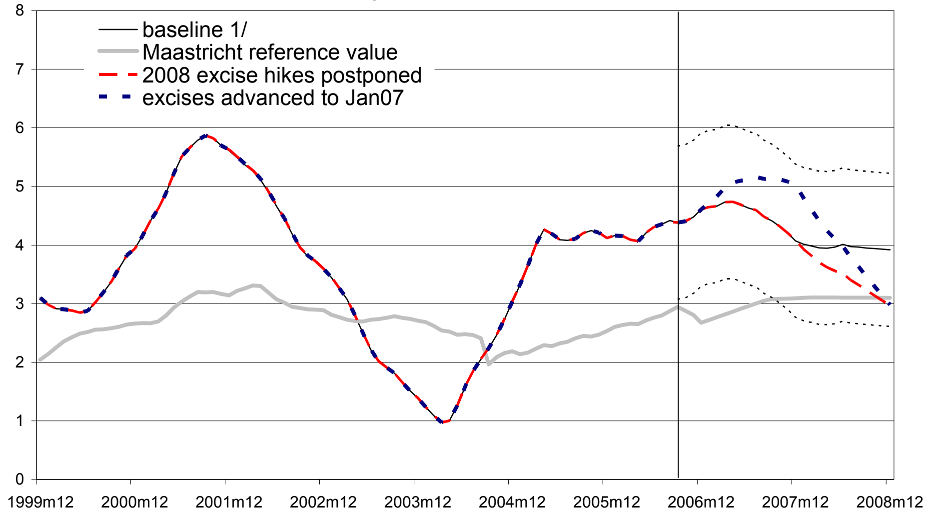
1/ Estonia: interest rates on new kroon-denominated loans to non-financial corporations and households with maturities over five years.
Lithuania: primary market yields of government bonds with maturities of close to ten years.
The rest of the new EU8 countries: secondary market yields of government bonds with maturities of close to ten years.
2/ Unweighted average excluding Estonia.
3/ Deficit data exclude pension reform costs.

market spreads, which are negligible, did not change perceptibly. Staff agreed that some delay would be manageable but stressed that overheating and convergence-related factors (such as the Balassa-Samuelson effect) could keep inflation above the Maastricht reference value for a protracted period. This would weaken one pillar of Estonia's CBA, a clear exit strategy. It would therefore be prudent to maintain a policy stance that would position the economy for euro entry as soon as external conditions turned favorable.

Box 4. Estonia: Inflation Projections

Staff's baseline projection, assuming current policies, suggests that Estonia will not meet the Maastricht inflation criterion before end-2008 unless there are beneficial shocks. But postponing excise tax increases (now planned for January 2008) or advancing them could bring inflation below the reference value in the second half of 2008.

Estonia: Annual Average HICP Inflation and the Maastricht Criterion



Source: Eurostat; Eesti Pank; and Fund staff estimates and projections.
1/ The dotted lines define one-standard-deviation confidence bands around this series' projection, where the standard deviation was calculated over the period 2000:1-2006:6.

Inflation projections are assembled from subindices. Core inflation (65 percent of the HICP basket) is linked to euro area inflation, which is moderating, and domestic demand pressures, which are rising. On balance, monthly core inflation is projected to remain close to its average level for January-August 2006. Administered prices (18 percent of the basket) are projected to evolve in line with announced government plans, as estimated by Eesti Pank staff. Nonadministered energy prices (7 percent) and unprocessed food prices (10 percent) are projected in line with the WEO for petroleum prices and food prices respectively.

Estonia: Inflation Developments and Projections Under the Baseline Scenario

					Projections		
	2003	2004	2005	Aug-06	2006	2007	2008
			In percent				
HICP (annual average)	1.4	3.0	4.1	4.4	4.6	4.1	3.9
HICP (year on year)	1.2	4.8	3.7	5.0	5.2	3.6	3.5
Aministered prices 1/	3.6	6.1	6.4	9.3	7.9	6.1	7.2
Nonadministered energy	-0.5	30.1	13.5	12.3	17.9	1.1	-3.1
Unprocessed food	-2.6	2.9	2.8	9.5	5.1	4.4	4.2
Core	1.2	2.2	1.9	3.1	3.1	3.1	3.1

1/ Including alcohol and tobacco.

18. **The authorities agreed but noted that their policy options were limited.** Given the CBA, the main macroeconomic instrument was fiscal policy which would have only a small impact on prices in a small open economy such as Estonia's. Thus even a strongly contractionary stance might not bring inflation down by enough, particularly if inflation was well above the Maastricht threshold. Nonetheless, as mentioned above, they would explore the possibility of shifting expenditures away from the nontraded sector which has become a significant contributor to inflation. Another instrument was the timing of planned excise increases, some of which are covered by commitments to the EU. Earlier this year one set of increases had been postponed from July 2006 to January 2008 in order to improve the chances of meeting the Maastricht criterion in 2007. Staff noted that, in view of new, higher, inflation projections, a case could now be made for making these increases in late 2006—the effect on inflation would then peak in late 2007 when the Maastricht target would be, in any event, out of reach. But the authorities felt that the timing could not be fine-tuned since the coalition agreement and (in their view) best practice precluded increasing any tax without a 6-month warning. Moreover, too rapid an increase could lead to a fall in revenue because of lower excises abroad. The authorities also planned to hold further discussions with EU institutions in an effort to seek an interpretation of the Maastricht inflation criterion that would be better suited to conditions in a rapidly converging economy.

D. Rapid Credit Growth

19. **Discussions focused on how to ensure that the risks associated with rapid credit growth are well assessed and properly priced.** In addition, staff reviewed changes in bank supervision since the 1999 FSAP and discussed the challenges facing the Financial Supervisory Authority (Box 5).[3]

20. **The FSA sees its main challenge as ensuring that banks' management—at parent institutions as well as local affiliates—are alive to the risks in a profitable but still immature market.** Since all the major banks are affiliates of reputable Nordic banking groups, and since their financial performance has been exemplary, the risks might appear minor, but the authorities did not consider them so. First, the loan market was immature: loan portfolios had grown under exceptionally benign circumstances—expanding opportunities for investment, fast-growing incomes, and declining interest rates—which had led to near-zero default ratios and exceptionally high profits (Table 5). It was possible that lenders and borrowers were both overestimating borrowers' capacity to repay under less favorable circumstances. Second, the major banking groups' Estonian exposure is relatively small but highly profitable. This has led to aggressive competition for market share and short-term incentives—not always resisted—to relax credit standards. Moreover, with risk assessments

[3] The authorities propose to schedule an FSAP update in late 2008.

Box 5. Bank Supervision in Estonia

Estonia's supervisory system was reshaped in 2002 when supervision was transferred from the Bank of Estonia to the new Financial Supervisory Authority (FSA), which was made responsible for all regulated financial intermediaries. In 2005 the FSA was reorganized on a functional basis in order to increase its effectiveness and make better use of its limited resources. The FSA is currently preparing for the adoption of Basel II. Keeping up with the large volume of new regulations, including from the EU, is a significant burden for this small institution.

Because the larger banks, and most of the smaller ones, are affiliates of regional groups, the FSA normally plays the subordinate role of host supervisor. This has required setting up a network of arrangements with other supervisors. Cooperation is reportedly good, facilitated by the relationships supervisory authorities maintain in the Nordic region. Supervisors meet regularly to discuss work programs. They also participate in each others' onsite work and exchange information derived from offsite work. These issues are being explored further by the Fund's Nordic-Baltic Regional Financial Sector project.

increasingly made at head offices it was not clear that credit standards were well-tailored to local conditions. Third, banks were heavily exposed to the booming real estate sector where rising prices had led to an erosion of income cover and to longer maturities. Overall, the authorities viewed the real estate-related risk—which could be triggered by a collapse of prices or a significant growth slowdown—as the greatest source of concern.

21. **But they noted that, so long as there was no visible asset deterioration, they had few tools to influence banks' risk management or the pace of credit growth.** A doubling of the risk weights on mortgages (to 100 percent) in March 2006 had had little impact on the growth of mortgage lending but did make banks create larger buffers against credit risk by bringing funds from abroad. Both the modest increase in reserve requirements (from 13 to 15 percent) effective September 2006 and efforts at moral suasion had mainly a signaling role. The scope for regulatory measures with more teeth was limited since banks could avoid regulation—and supervision—by booking loans abroad or transforming subsidiaries into branches. The main instrument available was thus to use supervisory interventions to ensure that banks were fully aware of the risks, including mismatches in households' balance sheets.[4] Along these lines, the FSA had placed real estate lending under particular scrutiny, requiring banks to provide detailed quarterly reports and a biannual questionnaire. The staff agreed that Estonia's financial integration limited the scope for further regulatory measures, or, for that matter, more intrusive, nonmarket measures.[5] This put a premium on strong

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[4] Balance sheet risks are discussed in an accompanying selected issues paper.

[5] The regulatory environment is already relatively tough: the new risk weight on mortgages is twice as high as set out in the EU's Capital Adequacy Directive and higher than in the other Baltic countries; and reserve requirements were higher than in the other Baltics even before the recent increase. Like other countries in the region, Estonia has steered clear of non-market measures to limit credit growth or capital inflows.

prudential supervision, and staff encouraged the FSA to press banks to make their stress tests more probing by analyzing more varied and more severe shocks.

22. **The staff (like the central bank) also urged the government to reduce or eliminate fiscal incentives which could fuel the property boom and were also distortionary.** The authorities responded that they intended to reduce the ceiling on the mortgage interest deduction by 40 percent, though this would only become effective in 2008. In other areas there was less readiness for change—there were no plans to increase property taxes and the authorities said it would be difficult to tighten the administration of capital gains taxation given the exemption of owners' primary residences.

E. Medium-Term Issues

23. **While discussions focused on short-term issues it was agreed that flexibility and productivity growth were key to containing medium-term risks.** In light of the poor demographic prospects and fiercer competition from abroad, productivity improvements were essential to growth. In particular, it would be important to align the educational system to the changing needs of enterprises and foster an environment supportive of research and development. To meet these challenges the authorities have introduced education and technology programs described in their *Action Plan for Jobs and Growth* for implementing the Lisbon Strategy. Labor and product market flexibility should also be preserved in order to support continued competitiveness gains. Flexibility and growth should both ease the adjustment necessary to shrink the external imbalance and stabilize the ratio of external obligations to national income. Staff estimates that if growth settles at 5-6 percent as projected in the staff's medium term macroeconomic framework the needed adjustment could be manageable—about 5 percentage points of GDP. But under more unfavorable assumptions it could be as high as 8-10 percentage points of GDP.[6]

III. Staff Appraisal

24. **After a decade and a half of rapid convergence, Estonia's very success is creating new challenges.** While growth is strong and competitiveness adequate, burgeoning demand is putting pressure on wages and prices that could undermine competitiveness and thus the foundation of sustained rapid growth. The blistering pace of credit growth may be compromising banks' assessment and pricing of risk. And inflation, while moderate, remains stubbornly above the Maastricht reference value, delaying euro adoption. The institutions that have underpinned Estonia's outstanding performance to date—flexible product and labor markets and an excellent investment climate—should help ride out these challenges by

[6] Debt projections show gross external debt ratio rising by nearly 10 percentage points of GDP by 2011, while "bounds tests" show increases in the order of 15 percentage points (Table 7). However, the current account deficit is projected to shrink to well below the level that stabilizes the debt ratio.

sustaining productivity-driven growth. But a countercyclical fiscal stance is needed to improve the odds for a soft landing and early euro adoption, and continued supervisory vigilance is needed to contain risks in the financial sector.

25. **While six years of surpluses testify to Estonia's commitment to fiscal probity, overheating pressures and the wide external current account deficit call for a tighter fiscal stance.** The surpluses planned for 2006 and 2007 are welcome but too small, implying a procyclical fiscal position. It would have been preferable to save all of the revenue overperformance in 2006, postpone programmed income tax cuts, and make the 2007 budget at least neutral on a cyclically adjusted basis. Better still would have been to take advantage of exceptionally strong economic growth to reduce the share of government expenditure in GDP, positioning the budget for future challenges such as the costs of an aging population.

26. **The macroeconomic impact of EU funds needs to be taken into account in budget planning.** Estonia's effective procedures for allocating structural funds have resulted in a rapid uptake, setting a standard for countries in the region. But, while EU projects will contribute to growth, they are also providing fiscal stimulus at a time when withdrawal is needed. This dilemma has no easy solution, as the authorities noted, but it does need to be addressed within the broader context of the budget. In setting priorities and timing the authorities will need to take into account the impact on demand, particularly in sectors—such as construction—where overheating is most pronounced. In addition, consideration could be given to attracting more competitive bids by easing conditions for contractors to make wider use of imported labor.

27. **The reluctance to take a countercyclical fiscal stance underscores the need to strengthen the budget framework.** Given the CBA and, in time, euro adoption, fiscal policy is the only instrument available for macroeconomic stabilization. Thus, at a minimum, automatic stabilizers should be allowed full play. A medium-term goal should therefore be to shift the focus of policy from targeting the fiscal balance to targeting medium term expenditure growth, allowing the fiscal balance to reflect the business cycle. A full-fledged medium-term expenditure framework will take time to implement, but the authorities can already start placing increased emphasis on expenditures. An important first step would be to end the practice of using supplementary budgets to spend cyclical increases in revenues.

28. **Euro adoption at an early date should be a key objective.** Estonia's readiness for the euro is indicated by its sustained strong performance under the nearly identical rigors of the CBA. The euro will lock in the benefits of the CBA and eliminate balance sheet risks associated with a separate currency. These risks are not large but they are increasing with growing external debt and currency mismatches. Some delay in euro adoption would be easily manageable, as has been shown by markets' unruffled response to a perceived two to three year postponement, but a longer or open-ended delay should be avoided. A clearly articulated strategy for euro adoption would also send a signal of Estonia's continued commitment to financial stability.

29. **Meeting the Maastricht inflation criterion will require getting the maximum effect from a limited set of instruments**. A tight fiscal posture, with particular attention to containing demand in the overheating construction sector, is the indispensable ingredient. The timing of planned excise increases will also have a major impact on the time path of inflation but involves a difficult judgment call. If the inflation threshold looks likely to remain out of reach in the near future, consideration could be given to increasing excises now. But if the recent drop in oil prices persists, bringing the inflation threshold within reach earlier, there would be a stronger case for maintaining the current calendar—though supported by a much tighter fiscal stance than is now contemplated. The government that takes office in early 2007 will need to make this assessment at the beginning of its mandate.

30. **The openness of the financial sector puts a premium on supervisory vigilance and cross-border cooperation.** Openness has brought major benefits, including an inflow of foreign savings intermediated by reputable regional banks. But it has also limited the authorities' ability to influence bank behavior by regulation. Against this background, the authorities' supervisory effort is appropriately focused on risks stemming from rapid credit growth, particularly in the real estate sector. To maximize effectiveness, the existing links with Nordic supervisors should be maintained and, if possible, strengthened. The objective should be to ensure that the foreign-owned banks are fully alert to the risks associated with their Estonian operations. Finally, although the property boom seems to have paused, the case remains strong for eliminating mortgage interest deductibility and other distortionary fiscal incentives for real estate investment.

31. It is recommended that the Article IV consultation with Estonia remain on the standard 12-month cycle.

Table 1. Estonia: Selected Macroeconomic Indicators, 2001–07
(In units as indicated)

	2001	2002	2003	2004	2005	2006	2007
						Projection	
National income, prices and wages							
Nominal GDP (kroons, billions)	108.2	121.4	132.9	146.7	173.1	198.4	223.9
GDP (euro, millions)	6,916	7,757	8,494	9,375	11,061	12,679	14,312
Real GDP growth (year-on-year in percent)	7.7	8.0	7.1	8.1	10.5	10.0	8.4
Average CPI (year-on-year change in percent)	5.8	3.6	1.3	3.0	4.1	4.7	4.1
GDP deflator (year-on-year change in percent)	5.2	3.8	2.3	2.1	6.8	4.2	4.1
Average monthly wage (year-on-year growth in percent)	13.0	10.9	9.7	7.8	11.4	15.0	10.0
Unemployment rate (ILO definition, percent)	12.6	10.3	10.0	9.7	7.9	6.3	6.3
Saving-investment balances (in percent of GDP)							
Domestic saving	22.9	21.7	21.4	23.6	24.8	22.7	21.9
Private	19.9	17.7	16.7	20.0	20.7	18.4	18.8
Public	3.1	4.0	4.7	3.7	4.1	4.3	3.1
Domestic investment	28.1	32.4	33.0	36.2	35.2	35.2	34.2
Private	25.2	28.9	30.1	33.4	31.8	30.9	30.0
Public	2.9	3.5	2.9	2.8	3.5	4.4	4.3
Foreign saving	5.2	10.6	11.6	12.5	10.5	12.5	12.3
General government (in percent of GDP)							
Revenue and grants	33.9	35.3	36.4	37.4	37.2	38.8	38.3
Expenditure and net lending	33.6	34.3	34.1	35.7	35.6	36.9	37.5
Fiscal balance	0.4	1.1	2.3	1.6	1.6	1.9	0.9
External sector (in percent of GDP)							
Trade balance	-12.5	-15.2	-16.3	-17.4	-13.5	-15.7	-14.4
Service balance	10.4	8.1	8.6	9.3	7.3	6.5	5.6
Current account	-5.2	-10.6	-11.6	-12.5	-10.5	-12.5	-12.3
Gross international reserves (euro, millions)	930	958	1098	1317	1647	1703	1801
in months of imports	2.4	2.4	2.4	2.5	2.5	2.1	2.0
Relative to gross short-term debt (including trade credits)	0.7	0.6	0.6	0.5	0.5	0.5	0.5
Gross external debt/GDP (in percent) 1/	53.6	57.9	66.0	78.3	86.0	85.7	86.4
Net external debt/GDP (in percent) 2/	9.8	16.7	20.5	25.2	27.2	29.1	31.5
General government external debt/GDP (in percent)							
Excluding government assets held abroad	2.8	2.8	2.9	2.7	2.3	2.0	1.0
Including government assets held abroad 3/	-0.6	-2.5	-5.2	-5.2	-5.3	-4.6	-4.9
Exchange rate (EEK/US$ - period average) 4/	17.5	16.6	13.9	12.6	12.6	…	…
Money and credit (year-on-year growth in percent)							
Domestic credit to nongovernment	22.2	27.8	27.0	31.2	33.4	…	…
Base money	-9.8	-1.5	14.6	24.0	33.0	…	…
Broad money	23.0	11.2	10.9	15.8	41.9	…	…

Social Indicators (reference year):
Population (2005): 1.347 million; **Per capita GDP** (2005): €7,830; **Life expectancy at birth** (2004): 77.8 (female) and 66.3 (male); **Poverty rate** (share of the population below the established risk-of-poverty line, 2003): 20.2 percent; **Main exports**: electrical equipment and parts.

Sources: Estonian authorities, and Fund staff estimates and projections.

1/ Includes trade credits.
2/ Net of portfolio assets (including money market instruments), financial derivative assets, other investment assets, and reserve assets held by Estonian residents.
3/ Includes the Stabilization Reserve Fund (SRF).
4/ The Estonian kroon is pegged at 15.6466 kroons to the euro.

Table 2. Estonia: Summary of General Government Operations, 2001–08[1/]
(In percent of GDP)

	2001	2002	2003	2004	2005	2006	2007	2008
						Projection		
Revenue and grants	33.9	35.3	36.4	37.4	37.2	38.8	38.3	38.1
Revenue	33.3	34.7	35.3	35.2	34.5	36.1	35.6	35.1
Tax revenue	29.4	30.6	31.1	30.8	30.3	31.9	31.4	30.9
Direct taxes	18.1	18.8	19.3	19.1	17.6	18.5	17.9	17.3
Personal income tax	6.6	6.4	6.6	6.5	5.6	5.9	5.7	5.4
Corporate profits tax	0.7	1.1	1.6	1.7	1.4	1.6	1.6	1.6
Social security tax	6.3	6.4	6.1	5.9	5.7	6.0	5.8	5.6
Medical insurance tax	4.1	4.2	4.2	4.2	4.1	4.4	4.3	4.2
Unemployment insurance tax	...	0.4	0.4	0.4	0.4	0.3	0.3	0.3
Land and property taxes	0.4	0.3	0.3	0.4	0.3	0.3	0.3	0.3
VAT	8.0	8.4	8.4	7.7	8.5	9.2	9.2	9.2
Excises	3.3	3.2	3.1	3.6	3.8	3.9	3.9	4.0
Other taxes (incl. on intern. trade)	0.0	0.2	0.2	0.3	0.4	0.4	0.4	0.4
Nontax revenue	3.9	4.0	4.2	4.4	4.2	4.2	4.2	4.2
Grants	0.6	0.6	1.1	2.2	2.7	2.7	2.8	3.0
Expenditure	33.6	34.3	34.1	35.7	35.6	36.9	37.5	37.6
Current expenditure	30.7	30.8	31.2	32.9	32.1	32.5	33.2	33.2
Expenditure on goods and services	20.0	20.0	19.9	20.3	20.4	19.7	20.6	20.8
Wages and salaries	6.8	6.9	7.6	7.4	6.9	6.9	6.9	6.9
Other goods and services	13.2	13.1	12.3	13.0	13.5	12.8	13.7	14.0
Current transfers and subsidies	10.4	10.7	11.1	12.4	11.6	12.6	12.4	12.2
Subsidies	0.7	0.9	1.1	1.3	0.7	1.9	1.9	1.7
Transfers to households	9.7	9.7	9.9	10.4	9.9	9.7	9.6	9.5
of which: Pensions	6.1	6.0	6.2	6.2	6.1	6.2	6.1	6.0
Family benefits	1.2	1.1	1.1	1.4	1.3	1.2	1.2	1.2
Sickness benefits	0.7	0.7	0.7	0.8	0.8	0.7	0.7	0.7
Unemployment benefits	0.1	0.1	0.2	0.2	0.1	0.1	0.1	0.1
Income maintenance	0.3	0.3	0.3	0.2	0.1	0.1	0.1	0.1
Disability benefits	0.4	0.5	0.5	0.4	0.4	0.3	0.3	0.3
Prescription drug benefits	0.6	0.6	0.6	0.6	0.5	0.5	0.5	0.5
Other	0.2	0.4	0.5	0.6	0.6	0.5	0.5	0.5
Transfers to the EU budget	...	...	...	0.6	1.0	1.0	1.0	1.0
Interest payments	0.2	0.2	0.2	0.2	0.2	0.1	0.1	0.1
Capital expenditure	2.9	3.5	2.9	2.8	3.5	4.4	4.3	4.4
Financial surplus (+) / deficit (-)	0.3	0.9	2.3	1.6	1.6	1.9	0.9	0.5
Net lending	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Overall surplus (+) / deficit (-)	0.4	1.1	2.3	1.6	1.6	1.9	0.9	0.5
Memorandum items:								
Primary fiscal balance (+, surplus)	0.6	1.3	2.5	1.9	1.8	2.0	1.0	0.6
Overall balance, ESA95 basis 2/	-0.3	0.4	2.0	2.3	2.3	...	...	...
Total general government debt								
Excluding government assets held abroad	4.5	5.3	5.7	5.2	4.6	...	...	...
Including government assets held abroad	1.2	0.0	-2.4	-2.8	-3.0	...	...	...
Nominal GDP (kroons, billion)	108.2	121.4	132.9	146.7	173.1	198.4	223.9	248.7

Sources: Data provided by the Estonian authorities, and Fund staff estimates and projections.

1/ Cash basis.
2/ Source: Estonia's Statistical Office; reflects general government data revised in September 2006 in line with revised national accounts data.

Table 3. Estonia: Summary Balance of Payments, 2001–11

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
						Projection					
	(In millions of euro)										
Current Account	-361	-825	-985	-1,173	-1,159	-1,589	-1,762	-1,877	-1,879	-1,900	-1,860
Primary Current Account 1/	-48	-480	-514	-665	-601	-1,020	-1,091	-1,064	-907	-752	-523
Trade Balance	-866	-1,180	-1,385	-1,630	-1,489	-1,986	-2,055	-2,047	-1,944	-1,841	-1,663
Exports	3,758	3,704	4,055	4,806	6,273	7,611	8,509	9,487	10,462	11,379	12,321
Of which : goods for processing	1,422	1,146	1,204	804	641	778	870	970	1,069	1,163	1,259
Imports	-4,623	-4,883	-5,440	-6,436	-7,762	-9,598	-10,564	-11,533	-12,406	-13,219	-13,984
Of which : goods for processing	-1,141	-964	-962	-674	-582	-719	-792	-864	-930	-991	-1,048
Services Balance	722	632	733	868	807	819	802	796	807	842	877
Receipts	1,798	1,800	1,960	2,279	2,546	2,767	2,978	3,205	3,449	3,712	3,995
of which: travel and tourism	569	585	592	717	765	831	895	963	1,036	1,115	1,200
Payments	-1,076	-1,168	-1,228	-1,412	-1,739	-1,947	-2,176	-2,408	-2,641	-2,870	-3,118
Income	-313	-345	-471	-508	-558	-570	-671	-813	-972	-1,148	-1,338
Current Transfers	96	67	138	97	80	147	162	187	230	246	264
Capital and Financial Account	321	834	1,167	1,376	1,485	1,645	1,860	2,115	2,377	2,464	2,653
Capital Transfers	16	41	44	73	113	252	287	343	445	482	523
Financial Account	305	794	1,123	1,303	1,372	1,393	1,574	1,772	1,932	1,981	2,130
Direct Investment 2/	377	167	685	559	1,855	550	587	607	623	652	737
From abroad	603	307	822	776	2,349	806	850	895	943	994	1,047
Outward (by Estonians)	-225	-140	-137	-217	-494	-256	-262	-288	-320	-342	-310
Net equity investment 2/	51	59	32	-44	-1,344	64	64	64	64	64	64
Loans and other investments 3/	-124	568	407	788	861	779	923	1,101	1,245	1,266	1,330
of which:											
Banks	-104	340	697	897	581	895	815	801	817	838	838
Government	-133	-194	-211	-45	-93	-128	-128	-128	-128	-128	-128
Monetary Authorities	-13	38	37	11	-44	3	3	3	3	3	3
Errors and Omissions	-7	50	-34	16	-14	0	0	0	0	0	0
Overall balance	-47	59	148	219	312	56	98	238	498	564	793
Memorandum Items:											
EEK/EURO exchange rate (period average)	15.6	15.6	15.6	15.6	15.6	...	...	...	...	...	...
Gross International Reserves (EURO millions) 4	930	958	1,098	1,317	1,647	1,703	1,801	2,039	2,537	3,100	3,893
In months of imports	2.4	2.4	2.4	2.5	2.5	2.1	2.0	2.1	2.5	2.8	3.3
Relative to gross short-term debt (ratio) 6/ 7/	0.7	0.6	0.6	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
	(In percent of GDP)										
Trade Balance	-12.5	-15.2	-16.3	-17.4	-13.5	-15.7	-14.4	-12.9	-11.1	-9.7	-8.1
Goods and Non-factor Services balance	-2.1	-7.1	-7.7	-8.1	-6.2	-9.2	-8.8	-7.9	-6.5	-5.3	-3.8
Current Account	-5.2	-10.6	-11.6	-12.5	-10.5	-12.5	-12.3	-11.8	-10.8	-10.0	-9.1
Primary Current Account 1/	-0.7	-6.2	-6.0	-7.1	-5.4	-8.0	-7.6	-6.7	-5.2	-4.0	-2.5
Services	10.4	8.1	8.6	9.3	7.3	6.5	5.6	5.0	4.6	4.4	4.3
Income	-4.5	-4.4	-5.5	-5.4	-5.0	-4.5	-4.7	-5.1	-5.6	-6.1	-6.5
of which:											
Compensation of employees, net	0.1	0.2	0.3	1.1	1.5	1.7	1.6	1.5	1.4	1.4	1.3
Reinvested earnings, net	-3.3	-2.2	-4.3	-4.8	-4.5	-4.1	-3.8	-3.6	-3.5	-3.4	-3.2
Total external debt 8/											
Gross	53.6	57.9	66.0	78.3	86.0	85.7	86.4	88.3	90.9	93.5	95.4
Net 9/	9.8	16.7	20.5	25.2	27.2	29.1	31.5	34.7	38.2	41.3	44.0
NIIP	-48.7	-54.3	-67.6	-88.5	-96.7	-100.4	-104.4	-109.1	-114.1	-119.0	-123.2
General government external debt 10/											
Excluding Govt. assets held abroad	2.8	2.8	2.9	2.7	2.3	2.0	1.0	0.9	0.8	0.8	0.7
Including Govt. assets held abroad	-0.6	-2.5	-5.2	-5.2	-5.3	-4.6	-4.9	-4.4	-4.0	-3.7	-3.4
Debt Service/Exports of GNFS (in percent)	8.0	9.8	11.2	12.4	12.9	12.6	12.9	13.3	13.7	15.2	15.6

Sources: Bank of Estonia and Fund staff estimates.

1/ Excluding interest payments, reinvested earnings and compensation of employees.
2/ The large FDI and equity investment flows in 2005 reflect the aquisition of remaining shares of Hansabank, most of which were held by foreigners, by the Swedish parent owner of the bank.
3/ Including operations in debt securities.
4/ Excludes Government deposits held abroad (including in the SRF).
5/ Changes in gross international reserves may differ from flows implied by overall balance of payments due to valuation changes.
6/ Includes trade credits.
7/ Short term debt is defined on the basis of original maturity.
8/ External debt is defined to include money market instruments and financial derivatives.
9/ Net of portfolio assets (including money market instruments), financial derivative assets, other investment assets, and reserve assets held by Estonian residents.
10/ Includes government guaranteed debt.

Table 4. Estonia: Macroeconomic Framework, 2001–11
(In percent of GDP, unless otherwise indicated)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
						Projection					
Domestic saving	22.9	21.7	21.4	23.6	24.8	22.7	21.9	21.6	21.9	22.0	22.0
Private	19.9	17.7	16.7	20.0	20.7	18.4	18.8	18.8	19.4	19.5	19.5
Public	3.1	4.0	4.7	3.7	4.1	4.3	3.1	2.7	2.5	2.5	2.6
Investment	28.1	32.4	33.0	36.2	35.2	35.2	34.2	33.4	32.6	32.0	31.1
Private	25.2	28.9	30.1	33.4	31.8	30.9	30.0	28.9	28.0	27.4	26.5
Public	2.9	3.5	2.9	2.8	3.5	4.4	4.3	4.4	4.6	4.6	4.6
Foreign saving	5.2	10.6	11.6	12.5	10.5	12.5	12.3	11.8	10.8	10.0	9.1
Memorandum items:											
Fiscal balance 1/	0.4	1.3	2.8	1.6	1.6	1.9	0.9	0.5	0.4	0.4	0.5
Revenues and grants	34.1	35.5	36.5	37.4	37.2	38.8	38.3	38.1	38.1	38.0	37.9
Expenditure and net lending	33.7	34.2	33.7	35.7	35.6	36.9	37.5	37.6	37.7	37.6	37.4
Net non-debt creating capital inflows ("+" inflow)	7.1	4.4	9.0	6.3	5.6	6.8	6.6	6.4	6.5	6.3	6.4
Capital transfers 2/	0.2	0.5	0.5	0.8	1.0	2.0	2.0	2.2	2.6	2.5	2.5
Net equity investment	0.8	0.9	0.4	-0.5	-12.2	0.5	0.4	0.4	0.4	0.3	0.3
Net foreign direct investment	6.0	2.9	8.1	6.0	16.8	4.3	4.1	3.8	3.6	3.4	3.6
GDP real growth (year-on-year in percent)	7.7	8.0	7.1	8.1	10.5	10.0	8.4	6.9	6.1	5.1	5.2
CPI inflation (average, year-on-year in percent)	5.8	3.6	1.3	3.0	4.1	4.7	4.1	3.9	3.5	3.2	3.2
CPI inflation (end-period, in percent)	4.2	2.7	1.1	5.0	3.6	5.4	3.6	3.5	3.4	3.2	3.2
Employment growth (average, year-on-year in percent)	0.9	1.4	1.5	0.2	2.0	5.8	0.1	0.2	0.2	0.1	0.1
GDP (billions of kroons)	108.2	121.4	132.9	146.7	173.1	198.4	223.9	248.7	273.0	296.2	321.5

Sources: Estonian authorities, and Fund staff estimates.

1/ Public savings minus public investment differs from the fiscal balance by the amount of capital transfers received from abroad.
2/ Mainly EU capital grants, all of which are channelled through the budget.

Table 5. Estonia: Selected Financial Indicators, 2000–06

	2000	2001	2002	2003	2004	2005	2006 August
	(In percent of total deposits)						
Banking sector reserves	23.2	13.6	11.2	13.5	16.2	16.7	16.2
Cash	3.7	3.1	2.7	2.6	2.2	1.7	1.5
Required reserves	15.9	16.3	16.7	20.5	26.6	25.8	29.6
Total reserves held at the BoE 1/	19.6	10.5	8.6	11.0	14.0	15.0	14.7
Average risk-weighted capital adequacy ratio	13.2	14.4	15.3	14.5	13.4	11.7	13.6
Non-performing loans (in percent of total loans) 2	1.0	1.3	0.8	0.4	0.3	0.2	0.2
Leverage ratio 3/	6.6	6.6	7.3	8.1	9.8	10.6	8.5

Sources: Bank of Estonia; and Fund staff estimates.

1/ Banks must meet reserve requirements on the basis of average reserve holdings over each reporting period. End-of-period levels can, therefore, be below required reserves. Starting in January 2001, up to 3 percentage points of the 13 percent reserve requirement could be met with high quality euro-denominated foreign instruments. In July 2001, the ceiling on the foreign share was raised to 50 percent. Effective September 2006, the reserve requirement was raised to 15 percent.

2/ Defined as loans overdue by 30–150 days. Under current regulations all non-performing loans over 150 days are written off.

3/ Defined as the ratio of total liabilities to total capital; a decline in the ratio indicates improvement.

Table 6. Estonia: Indicators of External Vulnerability, 2000–06
(In percent of GDP, unless otherwise indicated)

	2000	2001	2002	2003	2004	2005	2006	
Financial indicators								
Public sector debt 1/	4.5	4.5	5.3	5.7	5.2	4.6	...	
Broad money (year-on-year, in percent)	29.7	23.0	11.2	10.9	15.8	41.9	35.8	(Aug 2006)
M1 (year-on-year, in percent)	20.1	19.5	9.3	13.0	17.4	34.5	32.9	(Aug 2006)
Private sector credit (year-on-year, in percent) 2/	12.0	20.5	19.8	31.8	44.6	66.5	66.3	(Aug 2006)
External Indicators								
Exports (percent change, annual average, in euro)	52.3	4.1	-1.4	9.5	18.5	30.5	21.3	Projection
Imports (percent change, annual average, in euro)	41.5	4.3	5.6	11.4	18.3	20.6	23.7	Projection
Current account balance	-5.4	-5.2	-10.6	-11.6	-12.5	-10.5	-12.5	Projection
Capital and financial account balance	7.9	4.6	10.8	13.7	14.7	13.4	13.0	Projection
of which: Inward portfolio investment (debt securities etc.)	1.3	1.3	4.6	5.9	9.5	-9.6	...	
Other investment (loans, trade credits etc.)	0.0	-0.4	6.1	3.3	1.7	11.5	...	
Inward foreign direct investment	7.0	8.7	4.0	9.7	8.3	21.2	6.4	Projection
in the form of debt or loans	0.9	1.8	0.5	0.8	-0.3	-1.0	-0.5	Projection
Gross official reserves (in euro millions)	992	930	958	1,098	1,317	1,647	1,703	Projection
NFA of the consolidated banking system (in euro millions)	581	785	496	-68	-730	-667	-1,141	(Aug 2006)
Central Bank short-term foreign liabilities (in euro millions)	3.3	1.0	6.4	30.7	32.2	2.8	33.3	(Aug 2006)
Short term foreign assets of the financial sector (in euro millions) 3/	264	630	935	1,605	2,073	3,146	3,400	(June 2006)
Short term foreign liabilities of the financial sector (in euro millions)	868	979	1,399	1,733	2,806	2,613	2,873	(June 2006)
Foreign currency exposure of the financial sector (in euro millions)	510	1,064	1,576	2,007	2,174	633	790	(Aug 2006)
Official reserves in months of imports (excluding imports of goods for processing)	3.9	3.2	2.9	2.9	2.7	2.8	2.4	Projection
Broad money to reserves (ratio)	2.1	2.8	3.0	2.9	2.8	3.2	...	
Total short term external debt to reserves 4/	1.2	1.4	1.6	1.6	1.9	2.1	...	
Total external debt 5/	53.0	53.6	57.9	66.0	78.3	86.0	85.7	Projection
of which: Public sector debt 1/	3.4	2.8	2.8	2.9	2.7	2.3	2.0	Projection
Net external debt 6/	10.6	9.8	16.7	20.5	25.2	27.2	29.1	Projection
Debt service to exports of GNFS	6.8	8.0	9.8	11.2	12.4	12.9	12.6	Projection
External interest payments to exports of GNFS	-2.6	-2.8	-2.7	-2.3	-2.3	-2.4	…	
External amortization payments to exports of GNFS, in percent	4.9	5.2	7.1	8.9	10.2	10.5	9.8	Projection
Exchange rate (per US$, period average)	17.0	17.5	16.6	13.9	12.6	12.6	…	
REER, eop, appreciation (+)	-1.2	3.2	3.0	2.9	3.6	-0.6	…	
Financial Market Indicators								
Stock market index 7/	138.2	144.7	212.5	285.7	448.8	664.1	677.7	Sep 30
Foreign currency debt rating 8/	BBB+	A-	A-	A-	A	A	A	Sep 30
Money market spread 9/	0.87	0.72	0.34	0.50	0.37	0.19	-0.05	Jan-Sep

Sources: Country authorities, Bloomberg, Standard & Poor's, and Fund staff estimates.

1/ Total general government and government-guaranteed debt excluding government assets held abroad.
2/ Credit to households and nonfinancial institutions.
3/ Excluding reserve assets of the Bank of Estonia.
4/ By original maturity.
5/ External debt includes money market instruments and financial derivatives.
6/ Net of portfolio assets (including money market instruments), financial derivative assets, other investment assets, and reserve assets held by Estonian residents.
7/ Tallinn stock exchange index (TALSE), end of period.
8/ Standard & Poor's long-term foreign exchange sovereign rating.
9/ One-month spread between Tallinn interbank borrowing rate (TALIBOR) and the corresponding EURIBOR rate.

Table 7. Estonia: External Debt Sustainability Framework, 2001–11

		Actual					Projections						
		2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Debt-stabilizing non-interest current account 6/
1	**Baseline: External debt**	53.6	57.9	66.0	78.3	85.9	**85.7**	**86.4**	**88.3**	**90.9**	**93.5**	**95.4**	**-7.6**
2	Change in external debt	0.6	4.3	8.1	12.4	7.6	-0.3	0.7	1.9	2.6	2.6	1.9	
3	Identified external debt-creating flows (4+8+9)	-7.2	1.9	-1.9	0.8	-6.1	0.2	1.4	2.2	2.0	2.0	0.7	
4	Current account deficit, excluding interest payments	2.9	8.7	10.0	10.8	8.6	10.3	9.6	8.5	7.3	6.5	5.4	
5	Deficit in balance of goods and services	2.1	7.1	7.7	8.1	6.2	9.2	8.8	7.9	6.5	5.3	3.8	
6	Exports	80.3	70.9	70.8	75.6	79.7	81.8	80.3	79.8	79.7	79.7	79.4	
7	Imports	82.4	78.0	78.5	83.7	85.9	91.1	89.0	87.7	86.2	85.0	83.2	
8	Net non-debt creating capital inflows (negative)	-6.2	-2.9	-8.4	-5.5	-4.6	-4.8	-4.5	-4.2	-3.9	-3.8	-3.9	
9	Automatic debt dynamics 1/	-4.0	-3.9	-3.4	-4.5	-10.0	-5.3	-3.7	-2.0	-1.4	-0.7	-0.8	
10	Contribution from nominal interest rate	2.3	1.9	1.6	1.7	1.9	2.2	2.7	3.3	3.4	3.6	3.7	
11	Contribution from real GDP growth	-3.6	-3.8	-3.7	-4.8	-7.0	-7.5	-6.4	-5.4	-4.9	-4.3	-4.5	
12	Contribution from price and exchange rate changes 2/	-2.6	-2.0	-1.3	-1.4	-5.0	...	...	...	...	...	...	
13	Residual, incl. change in gross foreign assets (2-3) 3/	7.8	2.4	9.9	11.5	13.7	-0.5	-0.7	-0.3	0.6	0.6	1.2	
	External debt-to-exports ratio (in percent)	66.7	81.6	93.1	103.6	107.8	104.7	107.6	110.6	114.0	117.3	120.1	
	Gross external financing need (in billions of US dollars) 4/	1.8	2.5	3.1	3.7	4.5	6.0	6.5	6.9	7.3	8.0	8.4	
	in percent of GDP	26.5	32.2	36.2	39.4	41.0	47.7	45.4	43.4	42.0	42.1	41.0	
	Scenario with key variables at their historical averages 5/						**85.7**	**80.9**	**76.7**	**73.4**	**70.2**	**67.6**	**-12.8**
	Key Macroeconomic Assumptions Underlying Baseline												
	Real GDP growth (in percent)	7.7	8.0	7.1	8.1	10.5	10.0	8.4	6.9	6.1	5.1	5.2	
	GDP deflator in US dollars (change in percent)	5.3	3.8	2.3	2.1	6.8	4.2	4.1	3.9	3.5	3.2	3.2	
	Nominal external interest rate (in percent)	4.9	4.0	3.0	2.9	2.9	3.0	3.6	4.3	4.3	4.3	4.3	
	Growth of exports (US dollar terms, in percent)	6.8	-0.9	9.3	17.8	24.5	17.7	10.7	10.5	9.6	8.5	8.1	
	Growth of imports (US dollar terms, in percent)	5.5	6.2	10.2	17.7	21.1	21.5	10.4	9.4	7.9	6.9	6.3	
	Current account balance, excluding interest payments	-2.9	-8.7	-10.0	-10.8	-8.6	-10.3	-9.6	-8.5	-7.3	-6.5	-5.4	
	Net non-debt creating capital inflows	6.2	2.9	8.4	5.5	4.6	4.8	4.5	4.2	3.9	3.8	3.9	

1/ Derived as [r - g - p(1+g) + ea(1+r)]/(1+g+p+gp) times previous period debt stock, with r = nominal effective interest rate on external debt; p = change in domestic GDP deflator in US dollar terr
g = real GDP growth, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as [-p(1+g) + ea(1+r)]/(1+g+p+gp) times previous period debt stock. p increases with an appreciating domestic currency (e >
and rising inflation (based on the GDP deflator).
3/ For projection, line includes the impact of price and exchange rate changes.
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) re
at their levels of the last projection year.

APPENDIX I. ESTONIA: FUND RELATIONS[1]

(As of August 31, 2006)

The 2006 Article IV consultation discussions were held in Tallinn during August 15–25, 2006. The staff team comprised Mr. Rozwadowski (head), Ms. Choueiri and Mr. Lutz (all EUR), Mr. van Eden (FAD) and Mr. Hayward (MFD). Mr. Sierhej (Warsaw Office) conducted discussions on EU funds and Mr. Kosenko (Advisor, OED) attended a number of meetings. The mission met Prime Minister Ansip, Bank of Estonia (BE) Governor Lipstock, Finance Minister Sõerd, senior officials, parliamentarians, and private sector representatives. A press conference was held at the mission's end.

The authorities released the mission's concluding statement (http://www.eestipank.info/pub/en/majandus/IMF/_20060825.pdf) and have expressed their intention to publish the staff report.

Membership Status: Joined May 26, 1992; Article VIII.

General Resources Account:	**SDR Million**	**Percent of Quota**
Quota	65.20	100.0
Fund holdings of currency	65.20	99.9
Reserve position in Fund	0.01	0.01

SDR Department:	**SDR Million**	**Percent of Allocation**
Holdings	0.06	N.A.

Outstanding Purchases and Loans: None

Financial Arrangements: None

Projected Obligations to Fund: None

Exchange Rate Arrangements:

The currency of Estonia is the kroon. The kroon replaced the ruble on June 20, 1992. Since that date, the Bank of Estonia has guaranteed the conversion of kroon bank notes, coins, and reserve deposits of commercial banks at a fixed rate of exchange of EEK 15.6466 per euro

[1] Updated information relating to members= positions in the Fund can be found on the IMF web site (http://www.imf.org/external/np/tre/tad/index.htm).

(and EEK 8 per deutsche mark until 31 December, 2001). Estonia has accepted the obligations under Article VIII, Sections 2(a), 3, and 4 of the Fund's Articles of Agreement, and maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions, except for those imposed for security reasons in accordance with the European Council Regulations set forth in the letter from the Bank of Estonia dated November 17, 2006, and notified to the Executive Board in accordance with Decision No. 144-(52/51) (EBD/05/117, October 26, 2005).

Article IV Consultation:

The 2005 Article IV consultation was concluded by the Executive Board on October 26, 2005.

FSAP and ROSCs:

A review under the Financial Sector Assessment Program (FSAP) was completed at the time of the 2000 Article IV Consultation. Further Reports on Observance of Standards and Codes (ROSC) modules were discussed in the 2001 Article IV Consultations and updated during the 2002 Consultation.

Technical Assistance:

TECHNICAL ASSISTANCE FROM THE FUND, 2000–06

DEPT	Project	Action	Timing	Counterpart
FAD	Pension Reform	Mission	April 2000	Ministries of Finance and Social Affairs
MAE	Banking Supervision	Staff Visit	December 2000	Bank of Estonia
FAD	Tax Policy	Mission	March 2001	Ministry of Finance
INS	Financial Markets	Training	September 2002	Bank of Estonia
FAD	Medium-term Budget	Technical Assistance	December 2003	Ministry of Finance
FAD	Tax Reform	Technical Assistance	February 2005	Ministry of Finance

APPENDIX II. RELATIONS WITH THE WORLD BANK

1. Estonia became a member of the World Bank on June 23, 1992. The World Bank's early involvement in Estonia included work on public expenditure issues (1994), local government financing (1995), and the impact of the transition process on living standards (1996). In June 1997, the Bank completed a Public Expenditure Review Update.

2. In June 1999, the World Bank completed a Country Economic Memorandum entitled "*Estonia: Implementing the EU Accession Agenda.*" In February 2000, the World Bank initiated work on a Regional Development Program for the northeastern-most county of Estonia, Ida Virumaa. The work included the development of an action program designed to: (a) strengthen regional institutions providing labor and education services, as well as other social services; (b) support the development of small and medium enterprises; and (c) mitigate past environmental damages, contributing to sustainable development. The work was completed in June 2000.

3. The Board of Executive Directors approved the first World Bank lending operation in Estonia, a Rehabilitation Loan for US$30 million, in October 1992. In May 1994, loans to support district heating rehabilitation (US$38.4 million) and highway maintenance (US$12 million) were approved. A US$10 million Financial Institutions Development Loan (FIDL) was approved in October 1994, a health project (US$18 million) in January 1995, followed in April 1995 by an environment loan (US$2 million), and an agricultural loan (US$16 million) in March 1996. All the above-mentioned projects have already been completed and closed. In March 2000, the Board approved a Transport Sector Project (US$25 million), focusing primarily on road improvements. The project closing date is December 31, 2005.

4. The Bank's local office in Tallinn was closed in June 2001. In late 2003 Estonia opted to cancel the undisbursed World Bank loan balances, and the Bank's last active project (Transport Sector Project) was closed in December 2005. On September 17, 2006, Estonia changed from World Bank borrower status to donor status.

APPENDIX III. ESTONIA: STATISTICAL ISSUES

1. Data provision to the Fund is generally adequate for surveillance purposes, although fiscal data on general government operations is not always timely. The Data ROSC mission that visited Tallinn during May 10–18, 2001 found that the quality of the macroeconomic statistics was generally good. It noted that international standards and guidelines were generally followed. However, the quality of fiscal and monetary data was constrained by incomplete coverage.

2. Estonia is a subscriber to the Special Data Dissemination Standard (SDDS). The Bank of Estonia (BoE) publishes a wide variety of data on the key variables for each of the four sectors—monetary, fiscal, real and external—on its website, with periodic updates.

The following is a summary of both the frequency and the timeliness of key data as made available to Fund staff:

A. Monetary Statistics

3. All monetary data are issued by the BoE.[1]

- BoE balance sheet (base money and NIR) are reported monthly, and are available on the eighth day following the end of the month.[2]
- Broad money and its components are available monthly from the BoE on the thirteenth banking day from the beginning of the month.[2]
- Interest rate updates on domestic and foreign currency transactions are available monthly on the seventeenth banking day from the beginning of the month.[2]

B. Financial Statistics

4. All financial data are compiled by the BoE and are reported on a monthly basis:[3]

- Commercial bank reserves data are available on the eleventh banking day from the beginning of the month.[2]

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[1] All monetary data are collected with a frequency of 10 days and are available to Fund staff upon request.

[2] These are publicly available data on the Bank of Estonia website: http://www.bankofestonia.info/frontpage/en.

[3] Data for individual banks are also available on a quarterly basis.

- Commercial bank off-balance sheet data are available on the eighteenth banking day from the beginning of the month.[2]

- Average capital adequacy ratios are available on the thirteenth banking day from the beginning of the month.[2]

- Nonperforming loans data are available on the seventeenth banking day from the beginning of the month.[2]

- Leverage ratios are available on the eighteenth banking day from the beginning of the month.

- Liquidity ratios are available on the eighteenth banking day from the beginning of the month.

- NFAs of commercial banks are available on the eleventh banking day from the beginning of the month.[2]

- Net open foreign exchange positions are available on the eleventh banking day from the beginning of the month.

- Short-term external debt are available on the eighteenth banking day from the beginning of the month.

C. Balance of Payments Statistics

5. All balance of payments data are also compiled by the BoE:

- Daily exchange rate data are available with a one-working day lag.[2]

- Monthly imports/exports data are available with a two-month lag.

- Quarterly balance of payments data are available with a one-quarter lag.[2]

- Quarterly public and private external debt data are available with a one-quarter lag.[2]

D. Government Finance Statistics

6. All fiscal data are published by the Ministry of Finance (MoF). SDDS related data for central government operations have not been disseminated since December 2002.

- Monthly central government operations data are available with a lag of up to 25 days after the end of the month. The government has started to report monthly data on a consolidated government basis in January 1999 (http://www.fin.ee/?lang=en).

Currently, the MoF is using one of its two allowed SDDS flexibility options on the timeliness of monthly central government operations data, but it plans to begin redisseminating these data in the near future.

- Quarterly data on foreign loans and guarantees by the central government are available with a one-month lag. Currently, the MoF is using the second of its two allowed SDDS flexibility options on the timeliness of quarterly central government debt data, but it plans to begin redisseminating these data in the near future.

- Comprehensive annual cash data on central government and local government operations to 2001 are reported in the *GFS Yearbook 2005*. Balance sheet data is incomplete with only liabilities, domestic and foreign, reported. Only annual data to 2001 are reported in the *International Finance Statistics.* Annual general government operations data (cumulative) for 2002–05 are available on Estonia's National Summary Data Page (NSDP).

E. National Accounts Statistics

- Data on GDP (quarterly, by semester, and annually) are currently being issued by the Statistical Office of Estonia (SOE) with a lag of four months after the end of the quarter. Flash estimates of aggregate GDP are available two months after the end of the quarter.[4]

- Monthly CPI inflation data are available seven days after the end of the accounting period, and are received directly from the SOE. Monthly PPI and Export Price Index data are available four weeks after the end of the accounting period.[4]

- Monthly indicators of output, i.e., retail trade, industrial output, industrial sales, are reported approximately six weeks to two months after the end of the accounting period.[4]

Monthly wage data (nominal) are produced by the SOE with a two-month lag. Quarterly wage data (nominal and real) are produced by the SOE with a lag of two months.[4]

[4] Indicates publicly available data on the Statistical Office of Estonia website (http://www.stat.ee).

ESTONIA: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
(As of September 30, 2006)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]	Memo Items:	
						Data Quality – Methodological soundness[7]	Data Quality – Accuracy and reliability[8]
Exchange Rates	9/29/06	9/29/06	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]							
Reserve/Base Money	8/31/06	9/20/06	M	M	M	O, LO, LO, LO	O, O, O, NA
Broad Money	8/31/06	9/20/06	M	M	M		
Central Bank Balance Sheet	8/31/06	9/20/06	M	M	M		
Consolidated Balance Sheet of the Banking System	8/31/06	9/20/06	M	M	M		
Interest Rates[2]	Aug 06	9/01/06	M	M	M		
Consumer Price Index	Aug 06	9/07/06	M	M	M	O, O, O, O	LO, LO, O, LO
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]						LO, LO, O, O	LO, LO, O, NO
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government							
Stocks of Central Government and Central Government-Guaranteed Debt[5]							
External Current Account Balance	Q2 2006	9/26/06	Q	Q	Q	O, O, LO, O	O, O, O, O
Exports and Imports of Goods and Services	7/31/06	9/25/06	M	M	M		
GDP/GNP	Q2 2006	9/28/06	Q	Q	Q	O, O, O, LO	LO, LO, LO, LNO
Gross External Debt	Q2 2006	9/26/06	Q	Q	Q		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).
[7] Reflects the assessment provided in the data ROSC published on November 6, 2001 and based on the findings of the mission that took place during May 10-18, 2001 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).
[8] Same as footnote 7, except referring to international standards concerning (respectively) source data, statistical techniques and revision studies.

Statement by the IMF Staff Representative
November 17, 2006

This statement reports on data and official projections released subsequent to the finalization of the Staff Report. These developments underscore but do not change the thrust of the staff appraisal.

1. On November 8, the Bank of Estonia (BOE) published a revised economic forecast for 2006–08. The BOE's *growth* forecast for 2006 has been revised up to 11.8 percent, well above the staff's projection of 10 percent. The revision reflects more recent data on production and a more optimistic view of prospects for employment growth. For the following two years, BOE's growth projections are similar to staff's. BOE's new *inflation* projection is somewhat lower than staff's projection for 2006 because it incorporates the recent decline in fuel prices, but slightly higher than staff's projection in the outer years.

2. A flash estimate of third quarter balance of payments, released on November 13, shows a weakening of the current account relative to the previous two quarters and to staff projections. The third quarter current account deficit is estimated at 16 percent of projected third quarter GDP, bringing the current account ratio for the first three quarters to 14 percent. The deterioration appears to reflect mainly a sharp drop in export growth, only partly offset by a decline in import growth. While an explanation must await more detailed data, it is likely that the deficit for the year will be wider than the 12.5 percent of GDP projected by the staff and the central bank.

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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2006 Article IV Consultation with the Republic of Estonia

On November 17, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Estonia.[1]

Background

Estonia's commitment to free markets and prudent financial policies has paid off handsomely. Far-reaching structural reforms have created a well-functioning market economy, closely integrated with the Baltic and EU regions. A solid currency board arrangement (CBA) and prudent fiscal policy have brought price stability and low public debt. These policies have borne fruit with impressive productivity growth and a corresponding rise in real per capita income—the strongest convergence among the EU's new member states.

This very success is creating new challenges, including an overheating economy marked by tightening labor markets, rising inflation and a wide current account deficit. GDP growth rose above 10 percent in 2005 and is expected to continue at about the same rate in 2006. Domestic consumption, spurred by rising confidence, was the main driver of demand, though exports were also robust. Import growth has been even larger, however, further widening an already large current account deficit. On the supply side, growth has been supported by productivity increases which have, so far, kept up with real wages, and a surge in employment which has brought unemployment to a record low.

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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, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

The inflation rate—about 4½ percent annual average—is moderate for a fast-converging economy but has been kept higher than the Maastricht threshold by convergence effects, fuel prices, and, more recently, rising nontradables inflation—another symptom of overheating. With the other Maastricht criteria satisfied by comfortable margins, inflation is the main obstacle to euro adoption.

While the government budget has been in surplus for the last five years, the fiscal stance is expansionary because strong revenue growth, partly reflecting cyclical influences, has been matched by expenditure growth, including through supplementary budgets. The draft 2007 budget would loosen the fiscal stance further, with the general government surplus estimated to fall from 1.2 percent of GDP to 0.9 percent.

Economic growth has been associated with rapid credit growth, largely financed by Nordic banks through their Estonian affiliates. The banking system is financially sound, with high profitability and almost nonexistent bad loans. Nonetheless, in view of accelerating credit, highly concentrated in real estate, the authorities have recently taken prudential measures aimed at increasing risk buffers and have signaled concern about the risks of very rapid credit growth.

Executive Board Assessment

The Executive Directors commended Estonia's impressive convergence towards EU living standards, which is founded on a well-functioning and flexible market economy and on macroeconomic stability, anchored in a currency board arrangement (CBA) and a commitment to fiscal balance or surpluses. They noted that this success is giving rise to new challenges. Growth has risen above potential and the external current account deficit is widening. Strong demand is putting pressure on wages and prices, which could weaken competitiveness, while fast credit growth could compromise banks' assessment and pricing of risk. And, inflation, while moderate, remains above the Maastricht reference value, delaying euro adoption. Directors concurred that addressing these challenges will be key to sustaining the economy's enviable performance.

Directors commended the authorities for their commitment to fiscal rectitude. The surpluses projected for 2006 and budgeted for 2007 are welcome. However, they appear too small, implying an expansionary fiscal stance at a time when overheating pressures, higher-than-desired inflation, and a wide external current account deficit call for a tighter fiscal stance. Under these circumstances, it would be advisable to save the revenue overperformance in 2006, and plan for at least a neutral budget in 2007 on a cyclically-adjusted basis. Directors also emphasized that the exceptionally strong economic growth provides a welcome opportunity to reduce the share of government expenditure in GDP and address the challenges stemming from an aging population.

Directors observed that EU funds are complicating fiscal policy by providing an additional stimulus. They congratulated the authorities on their effective procedures in allocating structural EU funds, but cautioned that budget planning, including for the use of these funds, needs to take into account their macroeconomic impact, particularly in overheated sectors. In addition, Directors suggested that the authorities could lessen the pressure in overheated sectors by easing restrictions on foreign labor participation. At the same time, they also supported continued efforts to reduce skill mismatches, including through human capital development.

Directors welcomed the progress in implementing a medium-term budgeting framework and urged the authorities to eliminate the bias towards procyclical fiscal outcomes. This can be achieved by moving the focus of fiscal policy targeting from the overall balance to expenditure growth, allowing the balance to reflect the business cycle. Directors pointed out that significant early steps in this direction would be to focus budget discussions on expenditures and to end the practice of using supplementary budgets to spend cyclical revenue increases.

Directors concurred that early euro adoption should remain a key objective, as it would lock-in the benefits of the currency board arrangement and eliminate the risks associated with a separate currency. While these risks appear small in Estonia, they are increasing as external debt and currency mismatches rise. Accordingly, Directors considered that a modest delay in euro adoption would be easily manageable, but that a long or open-ended delay should be avoided. They encouraged the authorities to adopt a clearly articulated strategy for euro adoption.

Against this backdrop, Directors noted the challenge of meeting the Maastricht inflation criterion, which is the one criterion for euro adoption that is currently not met by Estonia. They concurred that efforts to contain inflation should be seen primarily as a means to firmly entrench macroeconomic stability. Directors considered that a tight fiscal policy will have to be at the core of the disinflation strategy.

Directors noted that Estonia's close financial integration in the region has created a strong institutional basis for financial deepening but puts a premium on cross-border cooperation and supervisory vigilance. While increases in reserve requirements and in the risk weights on mortgages earlier this year have sent an appropriate signal and led to more cushioning for risk, there is little scope for further regulatory measures of this nature. Consequently, Directors encouraged further strengthening of existing links between Estonian and Nordic supervisors to ensure that foreign banks internalize the risks of their Estonian operations. Banks should also be encouraged to improve risk management, including through more rigorous stress tests. Directors welcomed the authorities' plan to reduce mortgage interest deductibility and called for further steps to eliminate all distortionary fiscal incentives for real estate investment.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Republic of Estonia: Selected Economic Indicators

	2001	2002	2003	2004	2005
Real Economy	*In units as indicated*				
Real GDP growth, in percent	7.7	8.0	7.1	8.1	10.5
Average CPI inflation, in percent	5.8	3.6	1.3	3.0	4.1
Unemployment rate (ILO definition), in percent	12.6	10.3	10.0	9.7	7.9
Domestic saving, in percent of GDP	22.9	21.7	21.4	23.6	24.8
Domestic investment, in percent of GDP	28.1	32.4	33.0	36.2	35.2
Public Finance	*In percent of GDP*				
General government balance	0.4	1.1	2.3	1.6	1.6
General government debt					
Excluding government assets held abroad	4.5	5.3	5.7	5.2	4.6
Including government assets held abroad	1.2	0.0	-2.4	-2.8	-3.0
Money and Credit	*Changes in percent*				
Base money	-9.8	-1.5	14.6	24.0	33.0
Broad money	23.0	11.2	10.9	15.8	41.9
Domestic credit to nongovernment	22.2	27.8	27.0	31.2	33.4
Balance of Payments	*In percent of GDP*				
Goods and non-factor services balance	-2.1	-7.1	-7.7	-8.1	-6.2
Current account	-5.2	-10.6	-11.6	-12.5	-10.5
Gross international reserves (euro, millions)	930	958	1098	1317	1647
Exchange Rate					
Exchange rate regime	Currency Board Arrangement				
Exchange rate parity	EEK15.6466=€1				
Real effective exchange rate, end of period, 2000=100 1/	103.4	105.9	109.5	112.1	113.6

Sources: Estonian authorities, and IMF staff estimates.
1/ From INS, export-share weighted CPI real exchange rate against 15 major trading partners.

Statement by Tuomas Saarenheimo, Executive Director for Republic of Estonia and Timo Kosenko, Advisor to Executive Director
November 17, 2006

The Estonian authorities would like to express their appreciation to Mr. Rozwadowski and his team for open and constructive discussions and a set of high quality papers. The authorities agree with most of the assessments and recommendations put forward by staff. In the following, we briefly describe the general macroeconomic situation in Estonia and will focus on the key economic policy challenges thereafter.

General Macroeconomic Situation

Estonia has maintained high GDP growth since the last Article IV discussions and real convergence is well underway, bringing Estonia's real per capita income in PPP-terms to some 70 percent of the EU average by 2007, compared to about 50 percent only four years ago. Over a longer time horizon, high growth rates are sustained by strong productivity improvements, relatively flexible and open economic structures and by strengthened institutional capacity. The authorities share staff's assessment that cyclical factors are also at play and the economy is currently running above its potential. However, output expansion is expected to level off in 2007 and 2008 to 7-8 percent, which the authorities consider as Estonia's medium-term potential.

Against this backdrop, the authorities remain fully committed to strong macroeconomic policies. Estonia's policy framework is centered at the currency board and fixed rate of exchange, supported by tight fiscal policies and flexible markets. The general government budget has been in surplus for five consecutive years and the cumulative surplus for 2002 to 2006 amounts to around 8.6 percent of GDP (13.6 billion EEK). The authorities have prepared the 2007 budget with a view to avoid fiscal loosening and to ensure smooth macroeconomic adjustment. At the same time, the authorities recognize that the key task of fiscal policy, in particular in a small open economy, is to support a stable macroeconomic environment over longer term, and not fine-tune any specific economic indicator. Thus, they agree with staff on the importance of the medium-term budgetary framework.

The authorities note a few specific proposals in the staff report, namely to consider the postponement of the planned cut in the income tax and prioritizing the use of the EU funds with the aim to contain high growth in domestic demand. They emphasize that the income tax reform is an important part of a medium-term structural change in the tax system to reduce the share of direct taxes and is highly prioritized among the policy makers. With the reform being fiscally neutral, the authorities consider it important to complete their key policy commitment. However, they also note that the target of the tax reform was modified somewhat in 2003 and 2005. The uniform income tax rate will be reduced to 20 percent by 2009, instead of the initially planned 2006. Regarding the use of the EU funds, the authorities are fully committed to make sure that they are employed efficiently and in line with the well-established EU common policies, as also pointed out by staff. To this end, the authorities will adhere to their National Strategic Reference Framework to provide detailed framework in accordance with the Medium Term Budget Strategy. They also note that the allocation of the funds arising from the EU financial perspective for 2007-2013 is in the planning phase, and the authorities take fully into consideration the broader macroeconomic stance, including the projected slowdown in economic growth.

Medium Term Challenges and Competitiveness

Our Estonian authorities agree that maintaining competitiveness and rapid productivity growth remains a key precondition for sustained convergence in the medium- and long-term. Estonia's competitiveness is broadly adequate according to most commonly used indicators, including the REER trends being consistent with convergence developments. However, they note that ULC growth has accelerated recently and the nascent divergence in productivity and real wage growth in the first half of 2006 calls for close monitoring. The authorities take some comfort from Estonia's decent standings in most international comparisons of the business environment, and the Bank of Estonia's recent research also tends to confirm the flexibility in price and wage setting in Estonian companies.

However, further efforts are needed to maintain market flexibility and attractive business climate. The labor market is one of the most important contributors to the economy's long-term competitiveness. In the last couple of years Estonia's unemployment level has rapidly decreased, supported by market flexibility and the structural shift due to the opening up of the EU labor markets. Still the migration of Estonian workers has remained below that from most of the other new EU member states. In the future, further integration of European labor markets may add to labor supply in Estonia as well. From its part, the Estonian labor market is open to the intra-EU labor movement. In addition, the authorities have started discussion on a new Labor Contract Act, which among other changes simplifies the laying-off conditions for the companies. Also, the level of R&D expenditures has grown steadily, and R&D is among the priorities in targeting the EU funds.

Sustained productivity growth and market flexibility are also essential to ensure sustainability of Estonia's external position. At this stage of the long economic cycle, it is inevitable that part of high domestic investment is financed by foreign savings. As Estonia's domestic savings rate of 25 percent of GDP is increasing and economic growth is moving closer to potential, the outlook for the medium-term adjustment remains broadly favorable. Nevertheless, as the overall level of current account deficit is projected to narrow only moderately in the near future, the authorities closely follow external developments. The sustained level of FDI inflows (total FDI stock equals almost 100 percent of GDP) and the fact that the large part of cross-border capital flows takes place within financial groups are mitigating factors to avoid disruption in external financing.

Euro Adoption

Joining the euro area as soon as possible remains a key goal of the Estonian economic policy. With currency board and fixed rate of exchange towards euro in place for almost 15 years already, adoption of the euro is a natural economic policy objective. Estonia continues to fulfill all Maastricht criteria except the inflation criterion. The hike in international oil prices did not allow for reaching the Maastricht inflation criterion in late 2005 and early 2006, since the Estonian consumer basket is almost twice as highly exposed to changes in the world energy prices compared to that in the European Union. More recently, inflation has also been affected by factors related to convergence and cyclical position.

Estonian price developments continue to be very well in line with the equilibrating catching up process, and inflationary expectations are firmly anchored by the currency board framework. However, the recent inflation forecasts render the likelihood of euro adoption in 2008 and 2009 negligible. The authorities note staff's estimates that opportunities exist to reach the Maastricht inflation criterion in the second half of 2008. That would allow joining the euro area in 2010 at the earliest. Current stability and growth oriented policy framework remains the cornerstone in joining the common currency area. The authorities stay vigilant in monitoring closely the risks and market reaction associated with the delay in the euro adoption. Still, recent data indicate that given the continued strong policies, the postponement of the euro adoption has had no material impact on market expectations until now.

Financial Sector and Real Estate Market

The Estonian banking and financial system is fully integrated with the Nordic and international financial conglomerates. Nearly all financial institutions in Estonia operate under risk and liquidity management systems that are uniform across large regional financial groups. The structure of the financial system has had a strong impact on financial intermediation, allowing the mobilization of foreign savings and very substantial intertemporal consumption and investment smoothing. It also provides for virtually unlimited supply of credit, at least in the short-term. At the same time, sustained increase in disposable income has brought along higher demand for credit, in particular for mortgage borrowing. These developments have been accompanied by structural changes in economy and banking, bringing along lower interest rates and longer maturities.

Fundamental changes in the credit market have had their impact on real estate, especially on the housing market activity. In particular, households have made use of consumption smoothing opportunities to improve their living conditions. As a result, apartment prices in Tallinn increased almost 40 percent in 2005. However, in recent months, there are clear signs of cooling: apartment prices in Tallinn have increased on average by only about 10 percent compared to the end of 2005 and the selling periods have lengthened. It is important to underline that the biggest share of real estate activity is related to the housing market with only a limited amount of speculative transactions involved. There is also little evidence of home equity withdrawal for consumption. The authorities have started discussions to further limit the ceiling of mortgage interest deduction from personal income tax.

While being inherently beneficial for the economy, developments in the financial system pose new challenges for the authorities. Their main goal is to support full financial market integration in the EU, but rapid credit growth calls for a prudent approach domestically. The Bank of Estonia has somewhat tightened capital adequacy calculation and reserve requirement. However, the authorities consider strong cross-border cooperation as the key for effective risk assessment and crisis prevention to avoid sudden changes in credit supply. Recent stress tests on household loan portfolio indicate that the rise in unemployment to the highest level seen during the last decade in Estonia or a considerable increase in Euribor would affect only a tiny part of borrowers. Strong fiscal stance and gradual slowdown in income growth should contribute to lower credit demand in the private sector. An increasingly apparent slowdown of activity in the real estate market and the exhausted possibilities in improving credit conditions should with some lag start to be reflected in the credit growth as well.

The Economy's Balance Sheet

The robustness of the currency board arrangement and perceived low exchange rate risk has brought along currency mismatches in non-bank private sector balance sheets. It should be noted that the mismatches concern only liabilities in euros, which are allocated under very similar conditions to domestic currency loans. The maturity mismatches observed in the financial sector reflect the full integration of the Estonian financial sector to the Nordic markets that, as explained above, also involves centralized liquidity management. The authorities consider balance sheet mismatches to be mitigated by several factors, including the objective of the euro area accession. A big part of the net liability position is related to foreign direct investment stock (97 percent of GDP in 2005) reflecting an attractive investment climate. From the external debt point of view, gross levels (86 percent of GDP in 2005) are considerably mitigated by Estonian financial sector's intra-group flows mediator role that has kept net external debt low (18 percent of GDP in 2005). Notwithstanding, the authorities remain most vigilant in monitoring risks arising from balance sheet mismatches, especially as the euro area accession has been postponed, and remain dedicated to keeping a strong economic policy framework.