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**Statement by Mr. Solheim and Mr. Ross on Republic of Estonia
Executive Board Meeting
November 8, 2004**

Our Estonian authorities would like to express their appreciation to Mr. Haas and his team for the high quality work and the excellent set of papers. The authorities broadly agree with staff's analysis and recommendations, including on the challenges in the years ahead.

Recent economic developments and prospects

Estonia is in the middle of a broadly based cyclical upturn. The authorities expect the real GDP growth to reach at least 5.8 percent for 2004. Inflation picked up in the second quarter, mostly due to EU accession related factors, including the increase of the excise taxes, but it has subsided from then on. Therefore, the authorities' inflation forecast for 2004 remains unchanged at around 3 percent. The increase in labor productivity will be around 4.5 percent in 2004, up from last year and exceeding the expected 4 percent growth of real wages.

The medium term outlook is favorable with the output growth expected to reach the medium term potential of around 6 percent in 2005. The expansion will be underpinned by investments and acceleration of labor productivity growth. Inflation is projected to stay close to 3 percent both in 2005 and 2006, leaving room for a gradual nominal convergence, while still within the expected margins of the Maastricht criterion. The unemployment rate has declined below 9 percent in 2004, but although the situation in the labor market has gradually improved over the last years, the authorities are aware that the labor participation rate should be increased further if the robust output expansion is to be maintained.

Medium term adjustment of external accounts and credit market developments

The current account deficit has narrowed gradually from mid 2003, supported by a strong export performance. While the EU accession induced a one-off increase in imports and widened the external deficit temporarily in the second quarter, the trade deficit has since resumed a declining trend. The authorities expect the current account deficit to improve somewhat in 2004 as compared to last year. Net factor outflows, mostly reinvested earnings on the inward FDI, will amount to some 7 percent of GDP, more than half of the current account deficit. The inflow of foreign savings has remained robust with the gross FDI flows to Estonia exceeding 9 percent of GDP. As Estonia's investments abroad have increased as well, the net FDI flows will be around 6.5 percent of GDP for 2004, roughly one half of total capital inflows. Intra-group lending by Scandinavian financial conglomerates to their

Estonian subsidiaries and branches accounts for most of the remainder. Direct borrowing of enterprises remains subdued.

The rate of credit growth has remained broadly unchanged at around 30 percent. While the expansion of the total household borrowing has decelerated somewhat, its yearly growth is still around 40 percent, with mortgages accounting for 75 percent of the household debt. On the other hand, the reliance by the real sector on the domestic financial system has increased, as foreign direct borrowing from parent companies has been partly substituted by domestic bank lending. Thus, the modest decrease in the growth of household credit is partly offset by increased lending to enterprises. The financial leverage is still not very high with a household credit to GDP ratio equaling around 20 percent of GDP and the overall bank lending to the real sector amounting to 55 percent of GDP.

Fundamentally, the current account deficit and relatively high credit growth are considered natural at this stage of Estonia's development, reflecting the productivity catch-up and ongoing balance sheet adjustments. Indeed, the authorities welcome staff's balance sheet analysis that provides further evidence of domestic investment being the main factor underlying the current external deficit. Even if the one-off impact of the major infrastructure investments of 2002 and 2003 is gradually subsiding, the private investments are likely to remain strong. On the other hand, the public sector savings and high corporate profitability cannot at this stage fully compensate the households' inter-temporal consumption adjustment, underpinned by increasing productivity, higher incomes and efficient financial intermediation. Against this backdrop, the authorities expect the current account deficit to decline to 9 percent of GDP in 2006 and to around 6 percent of GDP over the medium term.

Macroeconomic policies in 2004 and 2005

The durable convergence with the Euro Area and meeting the Maastricht criteria in a sustainable manner are the overarching policy objectives of the Estonian authorities. The general policy framework remains firmly centered on the currency board and the ERM2 membership. The adjustment of the external position is the main policy concern, as the authorities are aware that the current account deficit cannot be sustained at the present level for long. Therefore, fiscal prudence and a strong financial sector are considered essential for the efficient functioning of the currency board and smooth participation in the ERM2 mechanism. Strong and transparent fiscal and structural policies are also seen as important for the formation of private sector expectations and investment decisions.

Monetary and financial sector policies

Estonia joined the ERM2 framework shortly after the EU accession. During the first four months in the mechanism, the Estonian kroon has not experienced any pressures and the short term interest rate differential against the Euro is negligible. Estonia will maintain its currency board as a unilateral commitment during the ERM2 membership.

The authorities plan to adopt the Euro at the earliest time possible, in accordance with the provisions of the EU treaty. Consequently, their policies on the monetary front are aimed

at maintaining an adequate size of banks' liquidity cushions while continuing technical preparations for joining the Eurosystem. The central bank has kept the statutory level of required reserves at 13 percent, but the changes in the calculation of the reserve base - to bring it fully in line with the ECB requirements - resulted in an increase of the effective reserve ratio by 1 percentage point in 2004. Moreover, the authorities are planning the adoption of the intraday liquidity instrument to increase the efficiency of the banks liquidity management.

The financial system is strong and well capitalized. The consolidated capital adequacy ratio stands close to 12 percent, above the legal minimum of 10 percent, and profitability is solid. Moreover, the share of non-performing loans has declined further to 0.4 percent of the total loan portfolio. Nevertheless, the still rapid credit growth calls for vigilance and the authorities have discussed internally the possible use of prudential ratios for counter-cyclical purposes. However, the outcome of the application of such measures would be suboptimal under the prevailing market structure, as all major financial institutions belong to the Nordic financial conglomerates. More importantly, the authorities have intensified their participation in supervisory cooperation on regional and EU levels.

The authorities are putting emphasis on analyzing the banks' own risk management systems, including in the context of preparing for the adoption of the Basle II framework. Moreover, they remain alert to address possible risks in the real estate and mortgage markets, as the growth of mortgage lending has not only enhanced the supply of new housing, but the prices have increased by 15 percent over the last year as well. Against this backdrop, the banks' lending practices are closely monitored to maintain the loan-to-value ratio broadly at 70 percent for housing loans. The authorities have also reduced by one half the upper limit on households' total tax deductible expenses, including interest payments on mortgages.

Estonia has in place a housing finance support scheme. A specialized governmental agency, Kredex, guarantees for certain groups of the population the initial down payment, typically around one third of the value of the underlying mortgage. The authorities regard this system as an important policy instrument, most notably to support the home ownership among young families. However, they recognize the need to balance the public policies against broader macroeconomic concerns. By October 2004, Kredex had fully used up the statutory limit of 700 million Estonian kroons on its mortgage guarantee portfolio and this proved to be an opportune time to modify the scheme to better target the new entrants to the housing market. The eligibility criteria for applicants were tightened and the maximum amount of a single guarantee reduced by 25 percent. The government decided also to increase the ceiling on the total amount of guarantees by 250 million Estonian kroons, considerably less than initially planned.

Fiscal policy

Estonia continues to adhere to a prudent fiscal stance, commensurate with a fixed exchange rate regime and fully in line with the EU framework. The authorities remain committed to maintaining the general government budget in surplus or balance over the

medium term, consistent with the provisions of the Stability and Growth Pact and the EU Treaty.

Against the stronger than projected output expansion, Estonia recorded a significant budget surplus of 2.9 percent of GDP in 2003, mostly accounted for by the functioning of automatic stabilizers. The central government's share in the surplus was allocated partly to the reserves of the public pillar of the pension system while the other part is set aside for upgrading the public education facilities. As the revenue performance has exceeded projections also in 2004, the government has prepared a supplementary budget to assign some of the expected over-performance to mostly education and environment-related investments. However, this supplementary budget, yet to be approved by the parliament, will add to government spending in 2004 by no more than some 0.2 percent of GDP. The authorities project the fiscal surplus to reach nearly 0.7 percent of GDP for the FY 2004, broadly in line with the cyclical position as the output growth would be slightly below its medium term potential. The amount of fiscal reserves is expected to be around 10 percent of GDP by the end of this year.

The authorities have submitted the FY 2005 budget to the parliament. It is fully balanced on the general government level, in line with the Budget Strategy for 2005-2008 that sets nominal expenditure ceilings for governmental agencies. On the structural front, the authorities will continue the tax reform with a view to decrease the share of direct taxes in the overall tax burden. They intend to decrease the flat income tax rate from 26 to 24 percent in 2005 while containing current expenditures and increasing excise duties, so that the tax reform will be fully financed. Looking forward, the authorities are preparing a comprehensive strategy of tax policies from 2005 to 2009 aiming, among other things, at a lower taxation of labor and the increase of the consumption and environmental taxes.

The local governments recorded a deficit of 0.4 percent of GDP in 2003, fully accounted for by one municipality, the capital city of Tallinn. During 2004, the deficit of municipalities has been reduced to half, as some local governments have reached the legal borrowing limits and, consequently, have contained their spending. The deficit of municipalities is expected not to increase from the current level of 0.2 percent of GDP in FY 2005. To strengthen the budgetary management in the municipalities, the government has prepared a draft Local Governments' Financial Management Act that would, among other things, tighten the limits of deficit and debt, and will introduce a requirement to maintain a liquidity reserve.

As discussed during the 2003 Article IV consultation, the Estonian authorities have established a separate company to manage all real estate holdings of the central government. Consequently, a part of the public investments in structures are recorded by the central government as financial investments in the real estate company, AS Riigi Kinnisvara. The audited accounts of AS Riigi Kinnisvara are publicly available over the internet, and the authorities have consulted with Eurostat to ensure full compliance of their rules with the EU regulations and practices.

Structural policies

The authorities continue to promote an advanced structural reform agenda to support balanced and sustained growth over the medium and long term, including by addressing long term fiscal challenges and by advancing reforms in product and labor markets within the framework of the Lisbon agenda.

The transition to the three-pillar pension system has been successfully completed. The first public pillar is financially sustainable, despite small inevitable transitory costs, and will turn firmly into surplus in a 10 year horizon. Estonia's health care system is based on a universal participation in the Health Insurance Fund and on the system of autonomous private and public service providers. The Health Insurance Fund, financed by the earmarked part of the payroll tax, is financially sound at present. Additionally, the reform of public hospital network is going on in accordance with the Hospital Master Plan 2015, approved by the government in 2003. However, the long term sustainability of the social policy framework depends ultimately on the actual replacement ratios and on the availability of finances to cope with higher medical costs in the future. In this regard, the authorities agree with the conclusions of staff's analysis on Estonia's aging and healthcare expenditures. At the same time, they believe that relatively high fiscal reserves and very low public debt will provide some support in coping with these challenges.

While agreeing with staff that labor market developments have been broadly favorable, the authorities are aware that more needs to be done to increase the employment rate. Further steps in labor market policies include a new draft Employment Contracts Act and an adopted National Action Plan of Employment. While the former is aimed at enhancing the flexibility of contractual relations between employers and employees, the latter will provide more focused services for training of the workforce and will increase the budgetary resources for the implementation of these priorities.

The authorities specified their timetable for the energy sector reform in 2004. In accordance with the EU Directives and provisions governing Estonia's accession to EU, Estonia's energy market will be fully opened for competition by 2012. Meanwhile, the joint stock company owned by major Finnish and Estonian energy suppliers has started the work to connect the Estonian and Scandinavian electric grids, thereby facilitating the gradual integration of Estonia's electricity market to the Scandinavian networks from 2006 and onwards.

Finally, the parliament has adopted a new law to support the voluntary mergers of the municipalities in order to streamline the system of local governments and to reduce their number. Financial incentives to encourage the unifications are provided in the FY 2005 budget. The authorities expect that the strict co-financing rules for use of the EU funds will have a catalytic role in this regard as well.