Statement by Jens Henriksson, Executive Director for the Republic of Estonia
March 2, 2009

The authorities would like to express their appreciation to Mr. Rozwadowski and his team for the thorough and candid policy consultations, and to Mr. Seelig for valuable discussions on the financial sector. The authorities broadly agree with staff's assessment and, as always, consider thoroughly the recommendations put forward.

The Estonian economy has undergone a major transformation over the past decade. The consistent macroeconomic policy framework based on market-oriented policies, openness and a currency board arrangement since 1992, has contributed to building of a broad-based economy and a strong government balance sheet, characterised by minimal public debt and substantial assets.

The currency board arrangement remains the main pillar for economic policies, complemented by the EU membership and the prospective EMU accession as cornerstones for the fast real convergence towards average EU income levels. GDP per capita (measured in PPP terms) has increased by approximately 250 percent since 1997. The fixed exchange rate regime implies that the economy exhibits flexibility in product and labour markets. These assumptions will be thoroughly tested in the current downturn, as the recent sharp deterioration in the external environment has lead to a rapid turnaround in domestic economic activity. Like staff, the authorities view the current situation a chance for speeding up the restructuring process of the economy in order to ensure sustained growth in productivity and output over the medium- to long-term.

The authorities have responded vigilantly to an ongoing economic slowdown. The vulnerabilities, especially those related to the current account deficit, credit growth and inflation, have decreased fast, indicating the capability of the economy to adequately react when the cycle turns. The uncertain external environment may pose more challenges for the future, especially for the short-term. However, the defences against a disorderly adjustment are strengthened by the fiscal and liquidity buffers, a strong and well-supervised banking system, ERM2 membership and the policy anchor of the EMU entry. Therefore, Estonia has entered the recession from a relative position of strength.

The outlook for 2009-2010

The Estonian economy is undergoing a sharp, but still an orderly economic adjustment. The authorities remain committed to prudent policies in order to ensure credibility of the economy and to restore the confidence of international investors.

The authorities' macro-economic projections for the Estonian economy have been revised downwards taking into account lower-than-expected growth of the main trading partners. More specifically, the risk scenario of the authorities' fall of 2008 forecasts is now considered to be a baseline, foreseeing a decline in the real GDP by 5–6 percent in 2009 and a slight growth (by about 1 percent) in 2010.

Inflation is declining sharply and is expected to turn negative in the second half of 2009. In January 2009, inflation dropped to 4 percent (y-o-y), down from 7 percent in December 2008, mainly due to lower motor fuel prices, extensive clothes and footwear sales and a favorable base effect. The authorities do not expect the inflation to exceed 2 percent in 2009.

Labor market flexibility will contribute strongly to a general economic adjustment. Indeed, the evidence over the last six months provides ample evidence that the labor market has been adjusting very rapidly, owing to the decentralized wage setting mechanisms, flexible salary structures and regional integration.

Labor market data for January is expected to confirm preliminary evidence of substantial wage moderation and an increase of part-time work. Tax data suggest that in December, wage growth slowed to 4 percent (y-o-y, down from the range of 15–20 percent) mainly due to a general cancelling of end-year performance bonuses. This is confirmed by recent data on wages with growth in the fourth quarter of 2008 at 6.9 percent. The annual nominal wage growth is expected to be negative in 2009. The registered level of unemployment (generally somewhat lower than the actual unemployment rate in Estonia) reached 6 percent in January 2009. To further streamline the reallocation of labor between economic activities, the new Employment Contract Law was adopted in January 2009 and will enter into force in July 2009. The new law, while raising the flexibility in the labor market, also increases unemployment benefit rates and broadens the range of beneficiaries to enhance security.

External stability

The current account deficit has contracted significantly due to a declining domestic demand, better than expected exports performance of services and the decrease in the outflow of profits via income account. Therefore, the dependence on current foreign financing is receding fast. The deficit in the combined current and capital account decreased from 16.9 percent of GDP in 2007 to 7.5 percent of GDP in the third quarter of 2008. The main contribution came from a narrowing trade deficit, on account of contracting domestic demand. The trade balance is likely to turn into balance or surplus in the coming years, and while the export volumes decrease as a result of a fall in transit trade, the share of higher value added goods in exports will grow.

The authorities note that some indicators in staff's calculations point to real exchange rate overvaluation of the Estonian kroon. Although the calculations are always based on certain assumptions, the authorities accept that the real exchange rate may have been somewhat overvalued in the recent past, but the ongoing adjustment challenges the persistence of the problem. As explained by staff, the authorities have addressed the potential capital account vulnerabilities by improving the financial safety net in coordination with the authorities of home countries of its banks.

Monetary policy

A currency board arrangement remains the over-arching pillar for monetary and financial stability by providing the credible anchor for price expectations over the medium and long term. Having CBA, Estonia has been mimicking life under the Euro area framework already for 17 years, reflecting the flexibility of its markets to adjust. The authorities strongly believe that an orderly entrance to the EMU is the only credible exit strategy from the current monetary arrangement.

As a member of the ERM-2 mechanism since 2004, Euro adoption remains a key policy priority of the Estonian authorities. The currency board has served the economy very well, confirmed by staff during all previous consultations, in keeping the inflation expectations low and serving as an anchor to economic agents' decisions.

Fiscal policy

Fiscal policy has an important role in economic policy making, *inter alia,* to ensure smooth functioning of the currency board arrangement. The Estonian authorities have followed a rule in their State Budget Law that implies an objective of a balanced budget. During the recent years of fast growth, and in concurrence with the Fund's advice, the authorities have run surplus budgets for six years to achieve the objective of a balanced or better budget over the cycle.

However, against the backdrop of the collapse in global demand towards the end of 2008 and the revised projections for 2009, the authorities prepared a negative supplementary budget that was passed by Parliament on February 20. The budgetary consolidation amounts to 3 percent of GDP and was achieved, among other measures, by effectively reducing the government's wage bill. The 2009 deficit will be financed by fiscal reserves and to a limited extent by low-cost project-based borrowing from international financial institutions. The authorities are aware that additional restrictive measures need to be developed for the 2010 budget, and take seriously staff's recommendations on medium-term budgetary planning.

At the same time, the long-term fiscal sustainability is not threatened. The budgetary impact of ageing is among the lowest in the EU. The general government of Estonia has a considerable net asset position, built during the recent years of fiscal surpluses. Financing of the deficit in 2008 has resulted in a decline in central government assets, to around 8½ percent of GDP at the end of 2008, but the fiscal reserves provide a necessary liquidity buffer for the government in these turbulent times. The latest fiscal measures aim at limiting the pace of the exhaustion of these assets.

Financial sector stability

Estonia's banking system is fully integrated with international groups, being the main intermediary of foreign funds to Estonia. 95 percent of Estonia's banking system comprises of the four large Nordic groups having established themselves either as branches or as subsidiaries. Notwithstanding the legal status of local banks, the capital and liquidity management of banks is *de facto* centralized at the group level. The recent experience in the context of global turmoil is providing evidence that intra-group financial flows have been a stable and reliable source of liquidity for the Estonian banking market. In light of regional financial integration, the banking sector measures taken recently by the Nordic authorities have played an additional stabilizing role.

Naturally, this market structure should rely on sufficient liquidity and capital buffers in host countries, on effective supervision, and, most notably, on smooth and efficient cooperation between the home and host authorities. We believe that Estonia's authorities have achieved satisfactory results in this regards, as is also confirmed by the FSSA report.

The capital and liquidity buffers are adequate to sustain the projected slowdown in the economy. In addition, the small size of the corporate debt and equity markets, limited number of market participants combined with virtually no government debt protect Estonia from being attractive to speculators. The high reserve requirement (currently 15 percent) and capital adequacy requirement above the international standard may not be the optimal policies for the long-term, but in the cyclical context and since the introduction of Basel II from January 2008, these are considered necessary safeguards. It is clear that the recent profitability levels will not be achieved for some time to come, but in the fourth quarter of 2008 the banks' profits were still at 17 million EUR level (in 2008, 0.25 billion EUR). An even more important indicator is the cost-to-income ratio of banks, which shows the flexibility of banks in reacting to external developments and has been maintained over the course of a turbulent 2008.

Notwithstanding the rapid deceleration of economic activity and the increase in non-performing loans, the capital adequacy remains high at 19.6 percent level as of end-January 2009, mainly because of retained profits from previous periods. The share of non-performing loans (60 days overdue) in the banks' loan portfolio is increasing from the very low levels, and reached 3.6 percent in end-January 2009. The authorities project it to increase to around 5 percent in 2009. As a reaction, banks have strengthened provisions further. At the same time, the banks consider themselves capable (without any state support) to liquidate collaterals (especially real estate), if necessary.

Credit growth to the private sector decreased significantly in 2008. While reflecting the impact of policy measures of the previous year, this slowdown was further supported by the rapid deterioration of the global conditions, but also of domestic credit demand. In 2009, credit growth might remain flat due to contracting economic activity. Although in the recent years the credit growth related to real estate has been strong, the share of indebted households remains low (22 percent of households according to the latest surveys). In the current environment where euro interest rates are declining, the Estonian borrowers benefit directly from lower debt-service costs on their variable interest rate euro-denominated loans.

The commercial banks in Estonia have sufficient funds. The banks do not see a need for additional state guarantees for the credit to the corporate sector (e.g. to exporting firms). Similarly, the authorities believe there is no need for extensive state intervention in the functioning of the financial system.