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Statement by Mr. Henriksson and Mr. Sutt on Republic of Estonia
Executive Board Meeting 10/1
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The authorities thank Mr. Rosenberg and his team for the frank and constructive discussions. They broadly agree with staff's assessment in most areas and as always consider thoroughly the mission's policy advice.

The Estonian economy has faced major challenges since the fall of 2008. The world economic crisis has put at test Estonia's economic resilience and its ability to adjust. The sharp decline in world trade and significant drop in domestic demand translated into a record output decline and sharp increase in unemployment. Despite the severity of the common external shock and significant domestic adjustment needs, the Estonian economy has stood up to the challenge and is now poised to a continued convergence.

Forceful policy response supported orderly adjustment

After the sharp and broad-based decline in activity, the economy has by now stabilized and the imbalances have closed in an orderly way. While domestic demand remains weak, the volume of goods and services exports has held up reasonably well. Estonia is part of the same supply chain with Scandinavian countries and there is no evidence that Estonia's position in this chain has deteriorated. However, like in several other countries, the inevitable cost of the adjustment has been a sharp increase in unemployment.

The currency board arrangement served Estonia well throughout the crisis. Flexible labor and product markets, full integration of banking and financial system with the European single market, and a timely fiscal response supported the confidence in the exchange rate regime. Credible policy implementation and improvement in global market conditions have reduced Estonia-specific perceived risks. Most financial confidence and vulnerability indicators are on a declining path, although not yet at their pre-crisis levels. Smooth functioning of the currency board continues to enable the borrowers to fully benefit from the ECB's monetary easing. All in all, Estonia's performance over the past year demonstrates yet again the ability of the economy to function efficiently under the regime of a firmly fixed exchange rate.

During 2008-2009, the authorities' fiscal policy was guided by a principle of balancing the short-term stimulus needs with the long-term sustainability target, in line with the European Union common policy framework. At the outset, the accumulated fiscal surpluses of previous

years, and the use of EU funds, enabled the government to moderately support the economy while keeping the consolidated budget deficit within the 3 percent limit set by the EU Stability and Growth Pact. During 2009 the size of budgetary consolidation reached approximately 9 percent of GDP. The Estonian government maintained a net creditor position vis-à-vis the rest of the world in 2009 with the general government gross debt at 6 percent of GDP and gross reserves amounting to around 12 percent of GDP by end-2009.

Financial stability and private sector indebtedness

Full integration with strong Scandinavian parent banks and the authorities' earlier measures to strengthen the banks' capital and liquidity buffers proved to be key strengths during the global financial crisis. Supervisory cooperation with home country authorities has been effective and further steps were taken in developing the cross-border crisis management framework, in line with FSAP recommendations.

The authorities estimate the NPLs to peak at 8 percent in 2010 and the cumulative write-downs to amount to around 5 percent of GDP. The loan-loss provisions equal now to about two thirds of the NPL's, implying a comfortable safety margin. Stress-tests run by the Estonian authorities as well as by the Swedish authorities at the banking group level indicate that banks could sustain losses well beyond the levels projected under both the baseline and risk scenario. Banks' ability to finance the economy remains strong. As the provisioning needs decrease and the operational efficiency is robust, banks are expected to return to profitability in 2010.

The authorities view the private sector debt level, at around 140 percent of GDP, which is close to the Euro area average, broadly consistent with the fundamentals, especially when taking into account the very low level of public debt. It also corresponds to the high level of financial sector development, manifested by high penetration rates in corporate and retail banking, wide use of financial products via multiple distribution channels and widespread use of advanced e-services.

However, the authorities fully agree that the ongoing adjustment of private sector balance sheets is called for after the rapid credit growth in previous years. This process is well underway. Credit stock is expected to decline by more than 6 percent in 2009 and remain broadly unchanged in 2010. As the capacity utilization is low, consumer confidence weak, and the recovery expected to be slow, the authorities forecast the demand for new credit to be modest. Hence, the credit growth will remain in check over the medium term.

Outlook and policy agenda for 2010-2011 and beyond

The overarching policy goal of the authorities is to support balanced recovery and sustained convergence of output and income in the years ahead. Euro adoption is the key short term economic policy priority.

The authorities expect the economy to grow at up to 1.5 percent in 2010 and between 3 to 5 percent in 2011, driven by productivity growth and external demand. Domestic demand

continues to be soft in the context of the post-boom restructuring and labor market adjustment. Unexpected negative developments in the world economy are seen as the biggest downside risk for the Estonian economy.

According to the preliminary estimates by the authorities, fiscal deficit for 2009 is expected to be well in line with earlier projections and remains clearly below the level of 3 percent of GDP. For 2010, the authorities are fully committed to keep the fiscal deficit firmly within the 3 percent limit. To that end, the authorities have implemented a range of revenue and expenditure measures with the estimated 2010-impact of 3 percent of GDP, in addition to a direct carry-over effect of 2009 deficit reduction steps on the 2010 budget. As noted by staff, the authorities increased some excise taxes in December 2009, supporting the budgetary revenues in 2010 by about 0.25 percent of GDP.

After further deficit reduction in 2011, the authorities aim at targeting the balanced budget by 2012 and return to surpluses thereafter. The strength of the medium-term fiscal stance will rely on further increasing the efficiency and flexibility of the fiscal framework. For that purpose, the authorities intend *inter alia* to reduce spending rigidities while further reinforcing expenditure controls and the role of strategic planning. On particular structural reforms to increase medium and long term fiscal sustainability, the cabinet has already decided to increase the retirement age to 65 years and to overhaul the system of special pensions. In January the government will discuss the phasing-out of the mortgage interest tax deductibility.

The authorities view domestic inflationary pressures subdued and the risk of deflation minimal. The mild deflation observed over the last quarters reflects ongoing corporate restructuring and inventory adjustment, decline in real wages and increase in unemployment as well as nascent global inflationary pressures. The past boom had narrowed the gap between the nominal price level in Estonia and the Euro area to a great extent. As wages are expected to continue the decline and stabilize only in 2011, the authorities estimate the inflation to stay low at below 2 percent level.

Maintaining an efficient labor market, a sustained increase in the number of employed and reducing unemployment are the most important medium-term priorities. Against the backdrop of recent steps that have further improved market flexibility, the authorities plan to implement active labor market policies over the next years with the targeted funding of 1/4 percent of GDP and focus on vocational training and retraining. In 2010, the funding of active labor market policies will grow 48 percent in comparison with the previous year. These policy measures with continued real convergence and revived FDI inflows are among key factors to reduce unemployment.

Geographical proximity, similar business culture and significant cost advantage, particularly in the labor cost, make Estonia attractive for investors, notably from world-competitive Scandinavian countries. Low government debt provides an opportunity to further develop investor-friendly business climate. On balance, the authorities estimate Estonia’s medium term growth potential to be in the order of 3-5 percent, maintaining the growth differential with the Euro area of about 1-3 percentage points over the next years.