

IMF Staff Visit to Estonia—Concluding Statement

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Estonia's enviable economic performance in the last decade and a half was marked by rapid real convergence and low inflation. This was facilitated by policies—a currency board arrangement (CBA), conservative fiscal policies, and liberal economic institutions—that created profitable investment opportunities and attracted a large inflow of private financing. Estonia's strong performance under the euro-based CBA testifies to its readiness to join the EMU, a step that would foster increased economic integration and eliminate risks associated with having a separate currency. While a rise in inflation precludes adopting the euro by January 2007, as was planned at ERM 2 accession, the authorities plan to limit the delay with policies aimed at bringing inflation below the Maastricht threshold by mid-2007. This is an appropriate objective. While eventual euro adoption will reduce financial risks, however, it will not warrant complacency: rapid convergence has necessarily led to vulnerabilities—a wide current account deficit, rapid credit growth and, more recently, potential overheating—that call for vigilant financial sector monitoring and a cautious fiscal stance. The key policy challenges will be the same under the euro as under the CBA.

Key macroeconomic developments in 2005 attest to the economy's continued dynamism.

Growth accelerated to nearly 10 percent, propelled by strong investment and an export boom. A pick-up in the private sector saving rate and a strong fiscal position contributed to a large decline in the current account deficit (relative to GDP). This is a significant turnaround after several years of widening deficits. Finally, the unemployment rate moved below 8 percent for the first time in ten years.

Inflation remained slightly higher than the euro area average, but was compatible with sustaining competitiveness under a fixed exchange rate or, by the same token, a currency union.

Estonia's relatively high inflation rate reflects catch-up effects associated with convergence as well as one-time exogenous factors: EU accession-related tax hikes in 2004 and higher energy prices in 2005. Second round effects of these increases were kept in check by low inflationary expectations under the CBA. Likewise, the significant decline in unemployment did not create additional inflationary pressures. Localized labor shortages emerged in a few sectors (construction, electronics), but aggregate wages rose by less than productivity and thus did not push up prices. Consequently, competitiveness remains robust, as is evident from indicators of real effective exchange rates and the continued rise in Estonia's world export market share.

Appropriately, the authorities have made euro adoption a main policy priority.

Estonia has achieved nominal convergence under its euro-linked CBA and has maintained a culture of stability as evidenced by its history of fiscal surpluses and low interest rate spreads. EMU membership would bring clear benefits: it would foster further economic integration, reduce transactions costs and eliminate risks associated with having a separate currency. The main cost, in principle, is that it would also eliminate the option of using the exchange rate to ease external adjustments and weather shocks. But in practice, given the large private sector foreign currency exposures built up during the last ten years, exchange rate policy is not a viable option, even without euro adoption. Moreover, Estonia has managed without monetary independence for a decade and a half, including during the Russia crisis of 1998; the flexible labor and product markets which helped the economy prosper under the CBA should do the same under a common currency.

Since the Maastricht inflation criterion is the one obstacle to early euro adoption, the authorities have prepared a policy package that aims to bring inflation below the reference value in the first half of 2007. In the absence of monetary policy instruments, their approach relies on rephrasing planned increases in excise taxes and keeping the fiscal stance as tight as possible. The objective and the proposed measures are both appropriate. Though Estonia already has a sustainable fiscal position there are good macroeconomic arguments for maintaining a tight stance at this stage in the cycle (see below). Moreover, reprogramming the excise tax increases involves no fundamental change in policy and would simply postpone a step increase in prices without changing the underlying inflation rate. Naturally, the strategy is not without risk. The volatility of inflation and the possibility of adverse external shocks imply that inflation could stay above the threshold in spite of the proposed policies. But neither can one rule out beneficial external shocks, as occurred in 2003. On balance, assuming a relatively benign external environment and a sufficiently strong fiscal posture, the authorities' policies have a good chance of succeeding.

Fiscal policy, the only instrument available to influence overall economic activity, will have to play a restrictive role in the run-up to euro adoption. For 2006, with output growth above potential, it is important to avoid a procyclical fiscal impulse. The mission therefore urges targeting a fiscal surplus at least as large as that achieved in 2005. Recent projections of a surplus equal to 1.8 percent of GDP suggest that this should be possible. For the medium term, a balanced budget remains a sound objective but it should be approached only gradually, with due attention to fiscal stabilization and the structure, sustainability and efficiency of recurrent spending. The 2007-10 fiscal strategy, now under preparation, is a good opportunity to initiate this process and to create room—within a balanced budget framework—to meet the challenges of EU transfers and the anticipated fiscal burden of an aging population.

Estonia's rapid convergence does not provide grounds for complacency and indeed has itself contributed to risks that call for vigilance and cautious policies. Three areas of risk are worth highlighting:

- *The possibility of overheating.* While productivity improvements could support high rates of growth for many more years, growth is now well above current estimates of potential growth (around 7 percent) and is thus not sustainable. Unchecked, this could lead to labor market pressures and, possibly, higher inflation. This calls for countercyclical budgetary policy to avoid fiscal stimulus and for continued efforts to increase labor market flexibility and boost labor force participation.
- *External imbalance.* The large external current account deficit—the counterpart of private capital inflows—is a side effect of catch-up growth, but is not sustainable in the long run. In time, the deficit will shrink as households and firms need to stabilize or reduce their foreign liabilities. This could require sizeable resource reallocations. The key to a smooth adjustment will be to sustain Estonia's liberal economic institutions and flexible labor market, which are the basis for a nimble, fast-growing economy. The current account improvement in 2005 illustrates that adjustment need not be disruptive if achieved against a background of rapid growth.
- *Rapid credit growth.* Low interest rates and strong investment demand have sparked exceptionally rapid credit growth, which raises prudential concerns, particularly since most borrowing is in foreign currency, albeit in euros. The authorities' concern is appropriately focused on the credit-financed real estate boom, possibly a bubble, which could end with

financial stress for households if growth stumbles or interest rates rise sharply. Although there are indications that real estate prices may have leveled off in early 2006, credit growth continues to be very rapid and supervisory vigilance is warranted. In this context, the tightening of capital requirements for mortgage lending, effective in March, was a welcome step. In addition, the present would be an opportune time to reduce or eliminate the tax incentives for mortgage borrowing.

Overall, Estonia is well placed to join the EMU and would benefit from membership. Early euro adoption is an appropriate target since this would reduce, if not eliminate, the risks faced by the economy as it continues on the path to real convergence. Nevertheless a delay would not create significant risks so long as the CBA continued to be underpinned by strong financial and structural policies.