

## Article IV Mission to Estonia—Concluding Statement

August 25, 2006

*Estonia's liberal economic institutions and macroeconomic stability—underpinned by the successful currency board arrangement (CBA)—have fostered exceptionally fast economic convergence. However, tightening macroeconomic conditions, exacerbated by rapid credit growth and new labor market opportunities abroad, are testing the resilience of labor and product markets and the sustainability of external competitiveness. This calls for a decisive policy response: fiscal tightening, focused on the overheating nontraded goods sector, and sustained supervisory vigilance over lending decisions that increasingly are made abroad. These policies should also support euro adoption, which is a key policy priority.*

### Background

1. **Estonia's rapid economic growth stems from its liberal economic institutions and conservative financial policies.** Real living standards now surpass those in most new member states of the European Union. Increasing trade and financial integration are offering new opportunities, but also creating imbalances. The challenge now is to implement policies that minimize the resulting risks to macroeconomic stability while continuing to profit from access to foreign markets and technologies.

2. **In the last year and a half economic growth has proceeded at an unsustainable pace.** Real GDP growth is projected at about 9½ percent in 2006, slightly below its 2005 level. While net exports made a positive contribution to demand in 2005, domestic demand is accelerating and the external current account deficit is expected to deteriorate to about 12 percent of GDP in 2006 despite continued strong export growth. The labor market has reached, if not exceeded, full employment, and wage pressures are evident in sectors affected by strong demand or foreign job opportunities. Labor shortages have emerged across many skill levels. Consumer confidence is at an all-time high, despite indications of a welcome respite in the buoyant real estate market. Investment remains strong, though the recent focus on construction may be at the expense of investments embodying new technology.

3. **Inflation is in the low single digits but remains above the euro area average—as expected in a rapidly converging economy.** The peg to the euro, combined with rapid economic convergence, implies that the underlying inflation rate is higher than in the euro area. Recently, however, rising energy prices and overheating pressures have also come into play. Looking forward, inflation should start declining in 2007 as the impact of past fuel price hikes wanes. If oil prices perform as suggested by futures, and overheating pressures are kept in check, the average HICP inflation rate could fall below 4 percent at end-2007.

### Fiscal policy

4. **Overheating pressures, the large current account deficit, and prospective aging-related expenditures all call for a tighter fiscal stance.** Tight market conditions have put wages and prices on a rising trend which, if sustained, could undermine competitiveness. Fiscal policy is the only macroeconomic policy instrument available to address these pressures. While it likely has only a modest impact in a very open economy such as Estonia's, the impact can be maximized by focusing

expenditure restraint on nontradeable goods, and the booming construction sector. A timely switch to a countercyclical fiscal position should increase the likelihood of a soft landing and help slow the real estate boom. In addition, the prospective fiscal impact of aging argues for an up-front strengthening of public finances.

5. **For 2006 the authorities should at least hold the line on expenditures.** Improvements in tax administration and stronger-than-anticipated growth have raised the projected surplus to 3.4 percent of GDP. The improved surplus relative to 2005 is welcome and testifies to a continuing commitment to sound fiscal management, but it does not withdraw stimulus as would be appropriate given that the economy is above potential. This is because the improvement in revenues also reflects higher EU transfers which—unlike taxes—do not reduce domestic demand. Therefore the authorities need to seek ways to give the supplementary budget a countercyclical thrust. This could be achieved by resisting increases in expenditures, particularly on nontradeable goods, and by channeling funds to items that do not increase domestic demand, such as capitalizing the pension and stabilization funds or purchasing assets abroad.

6. **Fiscal policy will need to be tightened in 2007.** The state budget strategy allows for an 18 percent increase in expenditure which is likely to produce a large injection rather than the needed withdrawal of fiscal stimulus. The expected rapid economic growth in 2007, and the associated increase in revenues, should create room for restraining expenditures across the board. One possible area is EU funded projects. While there is limited scope to slow expenditure on on-going projects, it would be prudent to reconsider the phasing of new projects. Although these add to productive capacity, implementing them too rapidly would increase demand pressures and could reduce value for money in light of currently high construction costs. In this connection the authorities could also consider lowering costs by easing conditions for importing labor, possibly on a temporary basis. In addition, consideration could be given to postponing the 1 percentage point reduction in the personal income tax rate and scaling back tax concessions for residential investment.

7. **The new multi-year state budget framework provides a welcome opportunity to merge Estonia's traditionally prudent fiscal policies with the government's expenditure priorities.** The use of this framework, in particular bottom up costing, will allow for a more careful assessment of the financial implications of achieving the government's objectives and priorities. It will be important to create the capacity needed to identify, cost and track program expenditure. Over the medium-term, consideration could be given to focusing the overall framework on a stable expenditure path commensurate with average expected economic growth, allowing the overall fiscal balance to reflect the business cycle.

### **Euro adoption**

8. **Euro adoption at an early date remains an appropriate objective.** It will lock in the benefits of the CBA and eliminate balance sheet risks associated with maintaining a separate currency. These risks, while not necessarily large, are increasing as households continue borrowing in euros and private sector external debt rises. The cost of euro adoption is negligible since Estonia has already performed admirably under the rigors of the CBA.

9. **Meeting the Maastricht inflation criterion will require a concerted effort to get the maximum possible effect from a limited set of instruments.** In the absence of monetary policy,

the main available measures are fiscal restraint and the timing of planned increases in excise taxes. The lagged impact of these measures, and uncertainty about future inflation, imply that an anti-inflation package cannot be fine-tuned. Given that under current policies the inflation criterion is likely to remain out of reach through 2008, attention should be focused on a strategy to maximize the probability of meeting it as soon as possible thereafter. Such a strategy would have two main components:

- Maintaining a tight fiscal posture. As noted above, this should be based on restraining spending on nontradeable goods;
- Increasing excises on alcohol, tobacco and fuel as soon as possible. If the increase is done quickly the effect on inflation will peak at a time when euro adoption is out of reach anyway. The effect will then decline to zero and thereafter inflation should remain lower than under current policies since excise increases will be in the past.

This strategy would send a clear signal of Estonia's commitment to euro adoption as well as its broader commitment to financial stability.

### **Financial market issues**

10. **Bank lending has grown extremely fast, readily funded by Nordic parent groups and leading to high real estate prices.** Although the credit to GDP ratio was initially low, it is now higher than in many other countries with comparable income levels. Moreover, lending is increasingly concentrated in the commercial and residential real estate sectors where property prices have increased sharply, particularly in late 2005. Despite intense competition for market share, however, interest rate spreads have now stopped declining. This, together with ECB moves on interest rates, has led to some rise in lending rates which in turn may have contributed to a levelling-off of real estate prices in recent months. Although spreads are now low, bank profitability has continued to increase, with growing volumes and sustained high asset quality. As domestic saving has not kept pace with lending, the demand for credit has been funded to a large extent by parent banks, whose Estonian exposures are small relative to their total balance sheets.

11. **The major risk is that a domestic or external shock could lead to borrowers becoming unable to service their debts, resulting in an abrupt tightening of credit conditions.** For example, although real estate prices appear to have stabilized at a high level, a price correction cannot be ruled out. A resulting increase in nonperforming loans would reduce bank profitability and could lead parent banks to review their exposure. Alternatively, borrowers, many of whom are new users of credit, as well as banks may have underestimated borrowers' ability to repay in less benign circumstances. For example, should unemployment rise unexpectedly, some borrowers would be able to service their debts only by scaling back spending in other areas, which could lead to a protracted period of weak demand and slow growth.

12. **Recent policy responses have been designed to send a strong signal without triggering disintermediation, which is a real risk in such an open system.** Too heavy-handed a response could drive business offshore where it would be even less amenable to monetary and supervisory pressure. The increase in the risk weighting for residential mortgages, effective last March, and an increase in reserve requirements, to take effect in September, were well judged and have had mainly

a signaling effect. The supervisory authorities will need to continue stressing their awareness of the risks and encourage banks to be prepared for any downturn in credit quality. More active use of scenario analysis and stress testing should ensure that bank managements become more alive to the risks and review their lending terms. With respect to mortgages, the removal of fiscal incentives, which have outlived their justification, could also help mitigate the risks.

### **Structural policies**

13. **Over the medium term, continued efforts are needed to maintain factor and product market flexibility and provide an environment to further raise productivity.** Sustained real convergence will require a shift towards production processes with higher value added. This means increased investment in human capital and better use of educational resources to develop the skills demanded by the market. Human capital investment will also help raise youth employment, easing current and prospective labor market pressures. Finally, efforts are needed to sustain labor and product market flexibility in order to ease the adoption of new technologies.