

**PRELIMINARY CONCLUSIONS OF THE 2011 ARTICLE IV MISSION TO ESTONIA**  
Tallinn, October 17, 2011

1. **A vibrant recovery has marked Estonia's first year in the euro area, albeit amid nascent tensions.** The economy's strong rebound has been grounded in a proven track record of prudent macroeconomic policies, which also underpinned a successful euro adoption and a recent credit rating upgrade. Moreover, Estonia earned the distinction of being the only EU country with a fiscal surplus in 2010, a feat likely to be repeated in 2011. But coming on the heels of one of the EU's deepest economic contractions, the recovery has exposed underlying difficulties. Price pressures have emerged (still mainly imported) and unemployment, while declining, remains high with long-term joblessness on the rise.

2. **Economic growth and price increases are however set to slow in 2012.** In line with weakening export markets, growth is projected to decline sharply. Still, leaving aside measurement uncertainties, the output gap will continue to narrow albeit at a slower pace. Inflation should moderate as the impact of shocks in global food and fuel prices dissipates. Core inflation's outlook remains uncertain in part given wage pressures stemming from labor shortages and mismatched skills. So far, wage increases have not exceeded productivity gains nor have real wages risen. These trends are likely to broadly continue but pressure can remain on core inflation.

3. **Downside risks to the outlook have increased.** With two-thirds of Estonia's exports going to the EU, recent European and global tensions have heightened the likelihood of adverse shocks. In addition to the aforementioned global trade developments, a generalized confidence fallout from the euro area sovereign debt crisis could exacerbate investor risk aversion and spill over to Estonia. In a severe tail-risk event engulfing core Europe, Estonia could face financial distress despite improved capital and liquidity positions of local and parent banks.

4. **Estonia's policy challenges entail preparing for short-term risks and boosting sustainable long-term growth.** As elaborated below, this will include enhancing Estonia's fiscal framework, locking-in financial sector resilience, and tapping its growth potential.

*Enhancing Estonia's Fiscal Framework*

5. **Estonia's fiscal position will remain strong, but the 2012 budget will entail a deficit of about 2¼ percent of GDP.** This primarily reflects a decline in revenues associated with the fall of CO<sub>2</sub>-permit receipts and pension pillar II contributions previously diverted to the budget. The budget also envisages a limited increase in expenditures, with large increases in public investment related to obligations from previous sales of CO<sub>2</sub> permits largely offset by curbing current spending growth.

6. **Limiting the stimulative impact of the 2012 budget will be needed.** The budget implies a positive fiscal impulse, largely from time-bound CO<sub>2</sub>-related investment obligations. But with the output gap closing in the central scenario, a neutral stance would be

appropriate. Recognizing that further substantial compression of current expenditures is unrealistic, strict observance of budgetary allocations as well as saving revenue windfalls, should these arise, will be essential. But if downside risks materialize, automatic stabilizers should be allowed to operate while maintaining Estonia's hard-earned credibility. This may require adhering to the Maastricht limit and can be supported by identifying contingency measures.

7. **Furthermore, the volatile global economic conditions also call for caution regarding the financing of the 2012 budget.** Estonia's fiscal reserves could be used to bypass volatile financial markets. But running down reserves now can leave Estonia with fewer options should the global shock persist or a tail risk scenario materialize. In this connection, alternative sources of finances should be considered, possibly including credit lines with commercial banks and tapping European Investment Bank resources.

8. **Looking beyond the current conjuncture, the authorities' medium-term target of a small surplus can safeguard Estonia's strong fiscal position but will require continued expenditure restraint.** Despite the authorities' long-standing record of fiscal conservatism, spending pressures will intensify as income convergence to EU levels proceeds. Specifically, the public sector wage freeze and deep cuts in operational spending to meet the Maastricht criteria will be tested. Also, medium-term pressures are set to emerge in pillar I of the old-age pension system and in disability pensions. The time-bound nature of CO<sub>2</sub>-related investments will help limit spending increases. Likewise, the authorities' ongoing efforts to enhance central government productivity through centralization of accounting and personnel management can help. Still, to achieve the fiscal target on a sustainable basis, the mission estimates that expenditures on non-wage goods and services would have to decline by at least 2 percentage points of GDP in the medium term. This would provide space to accommodate the authorities' welcome intention to reduce unemployment insurance contributions and restore fiscal buffers over time. Regardless, the pace of consolidation should be mindful of long-term investment needs and cyclical developments.

9. **A fully fledged multi-year fiscal framework can support the authorities' medium-term target, bolster Estonia's high fiscal credibility, and limit pro-cyclical policies.** A number of frameworks have been discussed and implemented in the European context and elsewhere. A successful framework for Estonia should reflect its fiscal tradition of simplicity and transparency, which has facilitated monitoring and accountability. Besides having as broad a coverage as possible, the framework's central element would be multi-year expenditure ceilings. These should be consistent with macroeconomic prospects and prudent revenue projections, as well as support the medium-term fiscal target of a small surplus. These ceilings could, for instance, be agreed for a four-year period when a new government takes office as in Finland, or be established on a rolling basis as in Sweden. Regardless, strictly adhering to them while revenue collections adjust to cyclical conditions will be essential for automatic stabilizers to operate. The framework could be established possibly as

a reform of the State Budget Act and should be mindful of evolving EU obligations, including the forthcoming economic governance “six-pack.”

10. **Fiscal buffers should continue to be an integral part of Estonia’s medium-term framework.** During the downturn, these buffers allowed Estonia to minimize the needed extent for (contractionary) pro-cyclical fiscal policy and reduced reliance on financial markets. Holding liquid assets nonetheless entails costs as well as benefits. A speedy accumulation of buffers could run the risk of weakening domestic demand and lowering long-run growth (by slowing public investment). In principle, fiscal buffers should be commensurate with the economy’s volatility, and Estonia’s output and fiscal revenue volatility suggests that higher buffers can be justified. But Estonia’s low financing needs suggest that the opposite is true. On balance, given the increasing global uncertainty, gradually rebuilding buffers to their pre-crisis level appears appropriate.

#### *Locking-in Estonia’s Financial Sector Resilience*

11. **Estonia’s mostly Nordic-owned banking system has weathered the global financial crisis.** Non-performing loans (NPLs) rose steadily in the aftermath of the Estonian housing market bust and Lehman Brothers’ bankruptcy, but these have declined more recently. At the same time, provisioning against loan losses has kept pace with the deterioration of asset quality. More generally, the Estonian banks’ average tier 1 capital ratio has continued to exceed international norms by a substantial margin, supported by banking sector profits that returned in the second quarter of 2010. The deposit guarantee fund’s assets have also increased and are approaching recommended levels.

12. **On balance, financial sector risks appear manageable but these have increased.** Estonian banks have scant direct and indirect (through parent banks) exposure to euro area sovereign debt. But local banks’ balance sheets remain at risk: household debt has remained high; about a quarter of mortgages have negative equity; almost all mortgages have flexible interest rates; and, banks continue to depend on foreign funding from their parent banks. While the latter has decreased and proven a stable source of financing, parent banks rely heavily on wholesale funding. Limiting potential financial contagion thus requires continued vigilance, particularly by:

- *Improving further cross-border supervision.* While the 2010 Nordic-Baltic Memorandum of Understanding is non-binding, it supports a long-standing close cooperation between home and host supervisors and provides a framework for crisis prevention and resolution. In a tail-risk event, regional crisis resolution tools would provide a critical backstop to Estonia’s sizable fiscal and financial buffers. However, progress on implementing its key elements—defining criteria for burden sharing and cross border bank resolution—has been slow.
- *Continuing preparations for Basel III.* Early and gradual institutional adoption of Basel III requirements, particularly regarding the liquidity framework and higher

quality capital, can reduce funding risks. This should be balanced, however, against the potential costs of reducing banks' margins and creating headwind for the recovery of credit conditions. In this regard, understanding the impact of Basel III on prudential ratios will prove critical to ensure that forward-looking capital buffers reassure markets. Moreover, coordination with home supervisors as well as consistency with forthcoming EU directives will be essential.

13. **In addition, further enhancing the regional and domestic bank resolution frameworks and addressing weaknesses in its bankruptcy law can support financial resilience and investment.** The recent adoption of a domestic bank resolution framework provides a welcome tool to facilitate rapid bank restructuring and minimize the cost of a bank failure. In addition, the Estonian Supreme Court's May 2011 decision on the Reorganization Act for corporations has provided a number of clarifications enhancing the law's effectiveness. Progress on bank asset separation and cross-border bank resolution tools, however, would also be welcome and will require progress at the regional level. In addition, Estonia's bankruptcy law merits attention to shorten the bankruptcy process. Achieving this as well as facilitating out-of-court restructuring can reduce costs and support the prompt release of resources to productive uses.

#### *Tapping Estonia's Sustainable Growth Potential*

14. **Bolstering sustainable growth will entail enhancing Estonia's attractiveness for FDI as well as addressing skill mismatches and increasing human capital.** Besides safeguarding competitiveness gains and continued rebalancing of the economy to the tradable sector, Estonia will need to move up the export value chain. The authorities' "Estonia 2020 Competitiveness Strategy" provides a welcome roadmap, including further improving the business environment to attract FDI with export potential. This would be supported by building up R&D capability and enhancing infrastructure with continued use of EU funds. Still, Estonia faces growing competition from emerging markets, particularly in Asia, for Nordic FDI, which heightens the urgency of boosting knowledge-based activities. Furthermore, fully drawing on Estonia's resources and developing their potential will also require addressing emerging labor market tensions. While its flexible labor market has enabled rapid declines in unemployment, long-term joblessness has risen. Despite double-digit unemployment, skill mismatches as well as alternative job options in Nordic neighbors have resulted in labor shortages and increases in manufacturing job vacancies. In this regard, the authorities' plans of harmonizing vocational education with labor market needs and increasing training are welcome. Looking forward, continued attention will be required to foster human resources in technical fields as well as to attract highly-trained individuals from abroad to support income convergence to EU levels.

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