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IMF Concludes Article IV Consultation with the Republic of Estonia

The IMF Executive Board on December 17, 1997 concluded the 1997 Article IV consultation[1] with the Republic of Estonia.

Background

In several respects, economic performance in Estonia during the past few years has been remarkable. This is largely due to its early decisions to establish a highly open economy based upon a liberal market-oriented trading and investment system accompanied by the discipline of a currency board arrangement. A relatively conservative fiscal stance and a strong commitment to structural reforms, aimed at minimizing direct participation of the state in the economy, have aided the rapid development of a vibrant private sector. By mid-1997, around 75 percent of the economy—in terms of output—was under private ownership including the banking system, services, and trade and most industry.

Real GDP increased by 4 percent in 1996 (the same as in 1995), and at an annual rate of almost 12 percent during the first half of 1997, while the unemployment rate remained stable. Inflation (as measured by the CPI) continued to decline in 1996, to about 23 percent and fell further to around 12 percent by November 1997. Domestic demand growth has been strong as both private consumption and investment increased in real terms during 1996 by an estimated 6.3 percent and 7.5 percent, respectively. Consequently, the external current account deficit widened from 5 percent of GDP in 1995 to around 10 percent in 1996 and is expected to remain high in 1997. Net capital inflows, including direct and portfolio investment, continued to rise and

[1]Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. In this PIN, the main features of the Board's discussion are described.

were sufficiently large to cover this deficit as well as result in an increase in net foreign assets of the banking system. Although both official and private external debt levels remain low, domestic bank credit has expanded at a relatively rapid rate.

The fiscal stance has been tightened in 1997. The general government position is expected to move from a deficit of 1.5 percent of GDP in 1996 to a surplus of at least 0.4 percent of GDP. Tax revenues continue to improve owing to rapid economic expansion, some new tax measures, and stronger tax administration; in addition, nontax receipts were boosted by a one-off transfer by the Estonia Shipping Company of accumulated profits to the government ahead of the company's privatization. At the same time, the ratio of general government expenditures to GDP is declining. To demonstrate its commitment to strengthening the fiscal stance, and to help provide a prudent margin for contingencies, the government has begun placing some of its accumulated financial savings into a newly created Stabilization Reserve Fund. The government has already placed EEK 500 million into this Fund, with an additional EEK 200 million to be added by end-1997.

On the monetary front, the currency board arrangement and the peg to the German mark continue to serve Estonia well by providing a transparent and credible framework for economic expectations. In order to safeguard its viability, the Estonian banking sector is subject to prudential norms that either match or exceed the levels recommended by the Basle Committee on Banking Supervision or European Union directives. During the past few months, as part of a broader package of measures to address the growth in domestic credit and improve the soundness of the financial system, the Bank of Estonia has raised the capital adequacy ratio to 10 percent and significantly increased the level of required reserves for banks. During the coming three months, these measures will be further reinforced as banks will be required from December 31, 1997 to set aside a general risk reserve of 5 percent of risk-weighted assets and off-balance sheet items, (ii) banks' minimum capital requirement will be raised to the equivalent of ECU 5 million (the EU recommended minimum) from January 1, 1998, and (iii) bank prudential regulations will be imposed on a consolidated basis for banks and their nonbank subsidiaries from the first quarter of 1998. Other specific measures to strengthen securities and capital markets are also expected to be implemented in coming months.

The objective of the medium-term program is to ensure that the macroeconomic gains made so far are not reversed, and that the framework of the Estonian economy—an open, liberal trade and payments regime as well as the currency board arrangement—is not jeopardized. To this end, the macroeconomic program for 1998 envisages an annual growth rate of real GDP of about 6 percent with inflation declining further to about 8 percent. In order to reduce demand pressures on the economy, the general government surplus is expected to increase to 1.8 percent of GDP and the current account deficit is projected to decline by over 2 percentage points. This will be accompanied by a more aggressive approach to financial sector surveillance including measures to strengthen banks' capital base, reduce systemic risks, and improve supervision of bank and nonbank financial institutions.

Executive Board Assessment

Executive Directors commended the authorities for the policies underlying Estonia's remarkable economic transition over the past few years, which were reflected, inter alia, in vigorous output growth and declining inflation. They noted that these favorable results were largely the outcome of early decisions to reduce the state sector and establish a highly open economy—based on a liberal trade and financial system—which was becoming well integrated with western Europe's advanced economies. In this connection, they welcomed the prospects of Estonia's entry into the European Union. In addition, Directors welcomed the favorable results of Estonia's adherence to the monetary and fiscal discipline implied by a currency board arrangement, which, coupled with the containment of real wage increases, had contributed to the strong macroeconomic performance.

Directors noted, however, that Estonia now faced some new problems in maintaining macroeconomic stability, namely, buoyant domestic demand fueled by rapid growth in bank credit, based in large part on substantial capital inflows, which had resulted in a sharp widening of the current account deficit to high levels. They cautioned that the banking system might overextend itself and face liquidity problems, should credit risks be poorly judged or capital inflows slow down. They also pointed out that inflation, while decreasing, was still uncomfortably high compared with that prevailing in major trading partner countries. This situation, in addition to demand-driven real wage increases—which, although relatively moderate so far, could exceed productivity gains—might result in a decline in competitiveness. Directors, therefore, emphasized the need to increase domestic savings, restrain domestic credit, strengthen the domestic financial system, and accelerate structural reforms.

Directors stressed that strong macroeconomic policies were especially important at a time of considerable volatility in international financial markets, to bolster policy credibility and market confidence. They underscored the importance of generating the fiscal surpluses targeted for 1997 and 1998, and to transfer these surpluses—including privatization proceeds—to the recently established Stabilization Reserve Fund. They supported the authorities' decision to refrain from spending any excess in revenues over and above the level of expenditures presently targeted in the program, as an important signal of the authorities' commitment to prudent economic management. Directors also endorsed the government's emphasis on lowering the still-high ratio of its expenditure to GDP. They urged the authorities to continue to focus on rationalizing public outlays, notably in the administrative budgets of the central and local governments.

Directors generally agreed that the currency board arrangement has been, and remains, an effective tool in Estonia, providing a transparent and credible framework for economic expectations. Directors viewed with concern the rapid expansion of domestic bank credit, all the more so because the pace of such growth could outstrip the banks' ability to assess risks properly. They commended the Bank of Estonia for aggressively availing itself of the policy instruments at its disposal—within the limitations imposed by the currency board arrangement —to reduce the growth rate of commercial bank credit and to strengthen the banking system. They encouraged the authorities to implement vigorously the reinforcement of bank prudential standards in the coming months; to extend this effort to nonbank financial intermediaries; and to strengthen bank supervision. With considerable volatility still evident in international markets, Directors counseled the authorities to monitor very closely financial developments in Estonia and to stand ready to take additional action if necessary.

Directors welcomed the authorities' commitment to revitalize structural reforms following the regrettable slowdown in 1996 and much of 1997. They emphasized that such reforms were essential for raising private savings and improving the efficiency and productivity of the economy. They urged the authorities to press ahead with privatization of the large infrastructure enterprises, reform of the pension system, and to improve anti-monopoly regulation and promote competition. In the financial area, Directors stressed the importance of rapidly adopting the amended credit institutions law and revised securities legislation to strengthen the financial system and to render it more transparent.

Directors commended the authorities for Estonia's tariff-free trade regime and urged them to make every effort to maintain it for as long as possible.

Press Information Notices (PINs) are a new series of IMF press notices (see Press Release 97/21). PINs are issued, at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies.

Estonia: Selected Economic Indicators

	1994	1995	1996	1997 1/
Real Economy		*Changes in percent*		
Real GDP	-1.8	4.3	4.0	7.0
CPI	47.7	28.9	23.1	11.2
Unemployment rate (in percent)	5.5	5.4	5.0	5.6
Domestic saving 2/	17.9	17.6	14.9	15.6
Domestic investment 2/	29.0	26.4	27.5	28.7
Public Finance		*In percent of GDP*		
General government balance	1.3	-1.2	-1.5	0.4
General government debt	7.3	6.7	6.9	6.8
Money and Credit		*Changes in percent*		
Base money	11.5	19.1	21.6	30.8
Broad money	29.6	31.3	36.8	48.8
Domestic credit to nongovernment	57.0	54.0	70.0	71.8
Balance of Payments		*In percent of GDP*		
Trade balance 3/	-15.5	-19.2	-24.3	-28.5
Current account 3/	-7.4	-5.1	-10.2	-12.2
Gross international reserves (in millions of US$)	447	583	640	687
Exchange Rate				
Exchange rate regime		Currency Board Arrangement		
Present rate		DM 8 = EEK 1		
Real effective exchange rate (1995 = 100)	85.5	100.0	108.0	111.0

Sources: Estonian authorities; and Fund staff estimates.

1/ Staff estimates.

2/ In percent of GDP.

3/ The Bank of Estonia has recently revised the balance of payments statistics, so that the 1996 trade and current account deficits are, respectively, 18.5 percent and 9.6 percent of GDP. Data for 1997 are also being revised, but such revisions are not reflected in the staff estimate for 1997.