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700 19th Street, NW
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IMF Executive Board Concludes 2008 Article IV Consultation with the Republic of Estonia

On March 2, 2009, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV Consultation with the Republic of Estonia.[1]

Background

Estonia's economy was already decelerating when the global financial crisis erupted. An outstanding economic performance since the early 1990s had ended in a strong credit boom and overheating in 2005-07. The real estate market had surged, output growth had risen well above potential, inflation had accelerated, and the current account deficit had widened significantly. These widening imbalances eventually raised awareness of increased risks, driving banks to tighten credit in early 2007. This, together with a decline in consumer confidence, triggered an economic slowdown. The global financial crisis brought further credit tightening and decline in confidence, leading to an acceleration of the slowdown in late 2007 and 2008.

The economy is now experiencing its most severe recession since the early 1990's. The downturn is mostly driven by domestic demand, as the credit crunch is squeezing investment and the decline in confidence is reducing consumption. The stock market index, which had soared in 2006, dropped below its pre-boom level, and real estate prices are now more than 20 percent below peak levels. As a result, GDP growth, which had started to decline in late 2007, turned strongly negative last year.

[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.

The recession is sharply reducing Estonia's imbalances. The external current account deficit nearly halved between 2007 and 2008, largely due to a demand-driven compression of imports but also helped by a drop in income outflows, reflecting the fall in profits to foreign-owned companies and banks. Exports continued to grow modestly despite an appreciation of the real exchange rate, owing to an improvement in terms of trade and a recovery of oil transit trade with Russia. Inflation, which reached double-digits in mid-2008 because of demand pressures as well as external and internal shocks, is now decelerating sharply as these pressures and the impact of the fuel and food price shocks have reversed.

Labor market conditions have begun to ease. Real wages continued to run ahead of productivity growth in 2008, compressing profits from their (exceptionally strong) 2006-07 level. But nominal wage growth has slowed from over 20 percent in 2007 to about 15 percent last year, and there are reports of cancelled or reduced bonuses. Also, the unemployment rate jumped by more than 2 percentage points in the third quarter of 2008 to above 6 percent, and there is growing evidence of large forthcoming slack in the labor market given the shrinking number of vacancies and widespread news of layoffs.

The financial sector has withstood the global financial turbulence well so far, but risks remain significant. Estonia's banks (almost entirely owned by large Nordic groups with centralized liquidity management) have so far had access to liquidity when needed (although at higher prices) through their parents which in turn benefited from liquidity support and guarantees by the home country authorities. Recently Eesti Pank and the Sveriges Riksbank have concluded an arrangement which will allow for expanded provision of liquidity to subsidiaries of Swedish banks in the event of need. As regards capitalization, strong profits in recent years have strengthened banks' buffers which have traditionally been robust given conservative regulatory limits. But the recession has started to erode asset quality (NPLs more than tripled in 2008, though from a very low level), undermining expected profit.

Estonia's track record of fiscal surpluses has allowed the accumulation of fiscal reserves that are proving crucial for the country's financial stability in this global crisis. However, large structural expenditure increases (particularly in the wage bill and pensions) over 2007-08 have tarnished this record. Together with the recession, they contributed to driving the general government balance into deficit in 2008, for the first time since the beginning of this decade. They have also set the stage for continued deficits over the medium term in the absence of corrective measures.

Executive Board Assessment

Directors commended the Estonian authorities for the progress made in recent years in achieving economic convergence and deepening real and financial ties with the European Union. Economic policies have built up considerable financial buffers, although sizable vulnerabilities have accumulated following a domestic consumption and housing boom that was fueled by high credit growth. With the global deleveraging, Estonia has entered a severe recession that will test the flexibility and resilience of its economy. The domestic demand contraction has already reduced the external current account deficit and lowered inflation. Recovery however will require a revival of foreign and domestic demand, continued financial stability, and prudent macroeconomic management.

Directors agreed that the currency board arrangement has served Estonia well by anchoring expectations and policies. Nonetheless, contagion risks have heightened. Directors considered, therefore, that euro accession would provide a safer haven. They noted staff's assessment that the real effective exchange rate is somewhat overvalued, but that competitiveness is projected to remain adequate as real wage increases are aligned with productivity.

Directors commended the authorities for their planned substantial fiscal restraint in 2009 that was intended to keep the fiscal deficit within the Maastricht ceiling of 3 percent of GDP. They considered that this fiscal stance would have had only a modest impact on activity, given the open economy and was necessary to support the currency board. Important steps to rein in the fiscal deficit included a freeze on the wage bill for 2009-10, which would also send a strong signal for wage moderation in the private sector, cuts in operational expenditures, and postponement of previously agreed tax reductions and pension increases. Directors encouraged the authorities to achieve a modest structural fiscal surplus over the medium term and supported their intention to review medium-term expenditures and revenue policies.

Directors noted that the financial sector has been thus far resilient to the global crisis. Nevertheless, loan quality will likely suffer as the recession progresses and liquidity buffers may erode further with global deleveraging. Against this background, Directors commended the authorities for their decisive steps to strengthen the bank resolution framework and financial safety nets, including regional safety net cooperation agreements. They welcomed the changes to the deposit guarantee scheme that reduce incentives for bank runs. They endorsed the recent swap agreement between the Estonian and Swedish central banks that underpin a new framework for extending emergency liquidity assistance to large banks, providing an additional liquidity cushion. They supported efforts aimed at improving regional collaboration through continued coordination of supervisory activities and exchange of information.

Structural policies to ensure market flexibility were considered by Executive Directors to be crucial for facilitating real adjustment including a reallocation of resources from the non-traded to the tradable sector and from low wage to high-value added activities. They supported the new labor contract law, which aims to reduce the, albeit limited, labor market rigidities, while improving the social safety net.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2008 Article IV Consultation with the Republic of Estonia is also available.

Republic of Estonia: Selected Economic Indicators

	2003	2004	2005	2006	2007
Real Economy	*In units as indicated*				
Real GDP growth (in percent)	7.1	7.5	9.2	10.4	6.3
Average HICP inflation (in percent)	1.4	3.0	4.1	4.4	6.7
Unemployment rate (ILO definition, percent)	10.0	9.7	7.9	5.9	4.7
Domestic saving (in percent of GDP)	21.9	22.6	24.2	21.9	19.8
Domestic investment (in percent of GDP)	33.2	34.3	34.2	38.6	37.9
Public Finance	*In percent of GDP*				
General government balance	2.5	1.6	1.6	3.3	3.0
General government debt					
Excluding government assets held abroad	5.6	5.6	5.0	4.4	4.3
Including government assets held abroad 3/	0.3	-2.4	-2.7	-3.1	-4.7
Money and credit	*Changes in percent*				
Base money	14.6	24.0	33.0	30.7	1.6
Broad money	10.9	15.8	41.9	28.2	13.5
Domestic credit to nongovernment	27.0	31.2	33.4	41.6	33.0
Balance of Payments	*In percent of GDP*				
Goods and nonfactor services	-7.4	-7.4	-6.4	-11.8	-11.3
Current account	-11.3	-11.7	-10.0	-16.7	-18.1
Gross international reserves (euro, millions)	1098	1317	1647	2128	2217
Exchange Rate					
Exchange rate regime	currency board arrangement				
Exchange rate parity	EEK 15.6466=€1				
Real effective exchange rate (percent change, period average; appreciation (+))	3.3	2.4	1.4	1.8	4.6

Sources: Estonian authorities, and Fund staff estimates.