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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 09/21-2

11:02 a.m., March 2, 2009

2. Republic of Estonia—2008 Article IV Consultation

Documents: BUFF/09/31; EBD/09/19; SM/09/47 and Correction 1, and Supplement 1; SM/09/48; SM/09/50 and Correction 1

Staff: Rozwadowski, EUR; Seelig, MCM; van der Willigen, SPR

Length: 1 hour, 1 minute

Executive Board Attendance

T. Kato, Acting Chair

Executive Directors	**Alternate Executive Directors**
	J. Sulemane (AE), Temporary
	K. Assimaidou (AF)
	J. Maciel (AG), Temporary
	S. Na (AU), Temporary
	J. Prader (BE)
	M. Agudelo (BR)
	J. He (CC)
R. Guzmán (CE)	
	S. O'Sullivan (CO)
	G. Purves (CO), Temporary
	B. Claveranne (FF)
K. Stein (GR)	
	P. Ray (IN), Temporary
	M. Xafa (IT)
	H.Yamaoka (JA)
	M. Daïri (MD)
A.S. Shaalan (MI)	
A. Bakker (NE)	
	J. Bergo (NO)
	A. Tolstikov (RU), Temporary
	S. Keshava (SA), Temporary
	A. Chua (ST)
	K. Zajdel-Kurowska (SZ)
M. Lundsager (UA)	
	R. Hills (UK), Temporary

G. R. Kincaid, Acting Secretary
T. Orav, Assistant

Also Present
IBRD: S. Ghosh, O. Kalantzopoulos. European Department: M. Belka, N. Choueiri, A. Gagales, A. Gulde-Wolf, M. Lutz, C. Rosenberg, F. Rozwadowski. Fiscal Affairs Department: J. Shields. Monetary and Capital Markets: S. Seelig. Secretary's Department: M. Miller, M. Yslas. Strategy, Policy, and Review Department: P. Rodriguez, T. van der Willigen. Western Hemisphere Department: F. Frantischek, M. Kaufman. Senior Advisors to Executive Directors: D. Abazorius (NO), W. Abdelati (MI), C.Dahlhaus (GR), J.Poulain (FF), N. Raman (ST), N. Riad (MI), W. Schilperoort (NE). Advisors to Executive Directors: N. Choudhary (IN), P. Gasiorowski (SZ), M. Ghassemi (MD), G. Jung (SZ), T. Kudiwu (AF), M. Leemets (NO), S. Lin (UA), A. Maciá (BR), D. Mevis (BE), C. Mira (CE), Y. Shinagawa (JA), D. Tartari (SZ), N. Thapa (ST), P. Wood (UA), J. Yang (CC).

2. REPUBLIC OF ESTONIA—2008 ARTICLE IV CONSULTATION

The staff representative from the European Department (Mr. Rozwadowski) submitted the following statement:

> This statement reports on data releases and policy measures since the staff report was issued. The additional information does not change the thrust of the staff appraisal.
>
> Preliminary data suggest that GDP fell sharply in the last quarter of 2008. Industrial production plummeted, and the decline in retail sales accelerated. A flash estimate puts real GDP growth at -9.4 percent year-on-year for the 4th quarter (-4.2 percent quarter-on-quarter, seasonally adjusted). These figures would imply that the economy contracted by 3.6 percent in 2008 instead of the 2.4 percent reported in the staff report. Carry-over effects would bring GDP growth to -6.2 percent in 2009 instead of the -4 percent in the staff report. This would produce a larger reduction in inflation and external current account deficit than in the staff report's baseline scenario, but it would also bring a greater deterioration in the performance of bank loans.
>
> The parliament has approved a supplementary budget for 2009 which further tightens the fiscal stance. The main measures are cuts in operational expenses (including the wage bill) in all ministries and a slowing of the pace of pension increases. The authorities estimate that these and other measures will reduce expenditure by about 3.25 percent of GDP which, under a 6.2 percent economic contraction, would reduce the general government deficit to about 1 percent of GDP. Their objective is to ensure the deficit would not exceed the Maastricht limit even if GDP falls as much as 8 percent in 2009.

Mr. Henriksson and Ms. Leemets submitted the following statement:

> The authorities would like to express their appreciation to Mr. Rozwadowski and his team for the thorough and candid policy consultations, and to Mr. Seelig for valuable discussions on the financial sector. The authorities broadly agree with staff's assessment and, as always, consider thoroughly the recommendations put forward.
>
> The Estonian economy has undergone a major transformation over the past decade. The consistent macroeconomic policy framework

based on market-oriented policies, openness and a currency board arrangement since 1992, has contributed to building of a broad-based economy and a strong government balance sheet, characterized by minimal public debt and substantial assets.

The currency board arrangement remains the main pillar for economic policies, complemented by the EU membership and the prospective EMU accession as cornerstones for the fast real convergence towards average EU income levels. GDP per capita (measured in PPP terms) has increased by approximately 250 percent since 1997. The fixed exchange rate regime implies that the economy exhibits flexibility in product and labor markets. These assumptions will be thoroughly tested in the current downturn, as the recent sharp deterioration in the external environment has lead to a rapid turnaround in domestic economic activity. Like staff, the authorities view the current situation a chance for speeding up the restructuring process of the economy in order to ensure sustained growth in productivity and output over the medium- to long-term.

The authorities have responded vigilantly to an ongoing economic slowdown. The vulnerabilities, especially those related to the current account deficit, credit growth and inflation, have decreased fast, indicating the capability of the economy to adequately react when the cycle turns. The uncertain external environment may pose more challenges for the future, especially for the short-term. However, the defenses against a disorderly adjustment are strengthened by the fiscal and liquidity buffers, a strong and well-supervised banking system, ERM2 membership and the policy anchor of the EMU entry. Therefore, Estonia has entered the recession from a relative position of strength.

The Outlook for 2009-2010

The Estonian economy is undergoing a sharp, but still an orderly economic adjustment. The authorities remain committed to prudent policies in order to ensure credibility of the economy and to restore the confidence of international investors.

The authorities' macro-economic projections for the Estonian economy have been revised downwards taking into account lower-than-expected growth of the main trading partners. More specifically, the risk scenario of the authorities' fall of 2008 forecasts is now

considered to be a baseline, foreseeing a decline in the real GDP by 5-6 percent in 2009 and a slight growth (by about 1 percent) in 2010.

Inflation is declining sharply and is expected to turn negative in the second half of 2009. In January 2009, inflation dropped to 4 percent (y-o-y), down from 7 percent in December 2008, mainly due to lower motor fuel prices, extensive clothes and footwear sales and a favorable base effect. The authorities do not expect the inflation to exceed 2 percent in 2009.

Labor market flexibility will contribute strongly to a general economic adjustment. Indeed, the evidence over the last six months provides ample evidence that the labor market has been adjusting very rapidly, owing to the decentralized wage setting mechanisms, flexible salary structures and regional integration.

Labor market data for January is expected to confirm preliminary evidence of substantial wage moderation and an increase of part-time work. Tax data suggest that in December, wage growth slowed to 4 percent (y-o-y, down from the range of 15–20 percent) mainly due to a general cancelling of end-year performance bonuses. This is confirmed by recent data on wages with growth in the fourth quarter of 2008 at 6.9 percent. The annual nominal wage growth is expected to be negative in 2009. The registered level of unemployment (generally somewhat lower than the actual unemployment rate in Estonia) reached 6 percent in January 2009. To further streamline the reallocation of labor between economic activities, the new Employment Contract Law was adopted in January 2009 and will enter into force in July 2009. The new law, while raising the flexibility in the labor market, also increases unemployment benefit rates and broadens the range of beneficiaries to enhance security.

External Stability

The current account deficit has contracted significantly due to a declining domestic demand, better than expected exports performance of services and the decrease in the outflow of profits via income account. Therefore, the dependence on current foreign financing is receding fast. The deficit in the combined current and capital account decreased from 16.9 percent of GDP in 2007 to 7.5 percent of GDP in the third quarter of 2008. The main contribution came from a narrowing trade deficit, on account of contracting domestic demand.

The trade balance is likely to turn into balance or surplus in the coming years, and while the export volumes decrease as a result of a fall in transit trade, the share of higher value added goods in exports will grow.

The authorities note that some indicators in staff's calculations point to real exchange rate overvaluation of the Estonian kroon. Although the calculations are always based on certain assumptions, the authorities accept that the real exchange rate may have been somewhat overvalued in the recent past, but the ongoing adjustment challenges the persistence of the problem. As explained by staff, the authorities have addressed the potential capital account vulnerabilities by improving the financial safety net in coordination with the authorities of home countries of its banks.

Monetary Policy

A currency board arrangement remains the over-arching pillar for monetary and financial stability by providing the credible anchor for price expectations over the medium and long term. Having CBA, Estonia has been mimicking life under the Euro area framework already for 17 years, reflecting the flexibility of its markets to adjust. The authorities strongly believe that an orderly entrance to the EMU is the only credible exit strategy from the current monetary arrangement.

As a member of the ERM-2 mechanism since 2004, Euro adoption remains a key policy priority of the Estonian authorities. The currency board has served the economy very well, confirmed by staff during all previous consultations, in keeping the inflation expectations low and serving as an anchor to economic agents' decisions.

Fiscal Policy

Fiscal policy has an important role in economic policy making, inter alia, to ensure smooth functioning of the currency board arrangement. The Estonian authorities have followed a rule in their State Budget Law that implies an objective of a balanced budget. During the recent years of fast growth, and in concurrence with the Fund's advice, the authorities have run surplus budgets for six years to achieve the objective of a balanced or better budget over the cycle.

However, against the backdrop of the collapse in global demand towards the end of 2008 and the revised projections for 2009, the authorities prepared a negative supplementary budget that was passed by Parliament on February 20. The budgetary consolidation amounts to 3 percent of GDP and was achieved, among other measures, by effectively reducing the government's wage bill. The 2009 deficit will be financed by fiscal reserves and to a limited extent by low-cost project-based borrowing from international financial institutions. The authorities are aware that additional restrictive measures need to be developed for the 2010 budget, and take seriously staff's recommendations on medium-term budgetary planning.

At the same time, the long-term fiscal sustainability is not threatened. The budgetary impact of ageing is among the lowest in the EU. The general government of Estonia has a considerable net asset position, built during the recent years of fiscal surpluses. Financing of the deficit in 2008 has resulted in a decline in central government assets, to around 8½ percent of GDP at the end of 2008, but the fiscal reserves provide a necessary liquidity buffer for the government in these turbulent times. The latest fiscal measures aim at limiting the pace of the exhaustion of these assets.

Financial Sector Stability

Estonia's banking system is fully integrated with international groups, being the main intermediary of foreign funds to Estonia. 95 percent of Estonia's banking system comprises of the four large Nordic groups having established themselves either as branches or as subsidiaries. Notwithstanding the legal status of local banks, the capital and liquidity management of banks is de facto centralized at the group level. The recent experience in the context of global turmoil is providing evidence that intra-group financial flows have been a stable and reliable source of liquidity for the Estonian banking market. In light of regional financial integration, the banking sector measures taken recently by the Nordic authorities have played an additional stabilizing role.

Naturally, this market structure should rely on sufficient liquidity and capital buffers in host countries, on effective supervision, and, most notably, on smooth and efficient cooperation between the home and host authorities. We believe that Estonia's authorities have

achieved satisfactory results in this regard, as is also confirmed by the FSSA report.

The capital and liquidity buffers are adequate to sustain the projected slowdown in the economy. In addition, the small size of the corporate debt and equity markets, limited number of market participants combined with virtually no government debt protect Estonia from being attractive to speculators. The high reserve requirement (currently 15 percent) and capital adequacy requirement above the international standard may not be the optimal policies for the long-term, but in the cyclical context and since the introduction of Basel II from January 2008, these are considered necessary safeguards. It is clear that the recent profitability levels will not be achieved for some time to come, but in the fourth quarter of 2008 the banks' profits were still at 17 million EUR level (in 2008, 0.25 billion EUR). An even more important indicator is the cost-to-income ratio of banks, which shows the flexibility of banks in reacting to external developments and has been maintained over the course of a turbulent 2008.

Notwithstanding the rapid deceleration of economic activity and the increase in non-performing loans, the capital adequacy remains high at 19.6 percent level as of end-January 2009, mainly because of retained profits from previous periods. The share of non-performing loans (60 days overdue) in the banks' loan portfolio is increasing from the very low levels, and reached 3.6 percent in end-January 2009. The authorities project it to increase to around 5 percent in 2009. As a reaction, banks have strengthened provisions further. At the same time, the banks consider themselves capable (without any state support) to liquidate collaterals (especially real estate), if necessary.

Credit growth to the private sector decreased significantly in 2008. While reflecting the impact of policy measures of the previous year, this slowdown was further supported by the rapid deterioration of the global conditions, but also of domestic credit demand. In 2009, credit growth might remain flat due to contracting economic activity. Although in the recent years the credit growth related to real estate has been strong, the share of indebted households remains low (22 percent of households according to the latest surveys). In the current environment where euro interest rates are declining, the Estonian borrowers benefit directly from lower debt-service costs on their variable interest rate euro-denominated loans.

The commercial banks in Estonia have sufficient funds. The banks do not see a need for additional state guarantees for the credit to the corporate sector (e.g. to exporting firms). Similarly, the authorities believe there is no need for extensive state intervention in the functioning of the financial system.

Mr. Rutayisire submitted the following statement:

We thank staff for the comprehensive set of papers and Mr. Henriksson and Ms. Leemets for their insightful statement on recent developments and challenges ahead in the Republic of Estonia.

We commend the Estonian authorities for progress made in recent years in boosting growth, improving employment, and deepening economic and financial ties with the EU. These outcomes were made possible thanks to the implementation of prudent macroeconomic policies and far-reaching structural reforms, which helped achieve a real GDP growth averaging 10 percent in 2005-2006. However, after several years of rapid expansion, Estonia has started to experience a deceleration of its economic activity in 2007, driven by a weak domestic demand. The ongoing global financial crisis brought further credit tightening and decline in confidence, leading to a negative real GDP growth in 2008. Nevertheless, we welcome the efforts that the authorities have made in reducing vulnerabilities, mostly related to the current account deficit, credit growth and inflation. Also noteworthy is the fact that Estonia's strong financial sector, together with its currency board arrangement, has helped the country to weather well the 2008 global financial turbulence.

Overall, we commend the authorities for these achievements, even though much is still needed to fulfill all the Maastricht criteria. We, therefore, encourage the authorities to focus their efforts on bringing inflation down to the targeted Maastricht threshold, maintaining macroeconomic stability, while boosting near-term and medium-term growth. Given the strong trade and investment ties that exist across the Baltics and the uncertainty surrounding Estonia's growth prospects, a close monitoring of the ongoing developments within the region is crucial to avoid worsening the performances achieved so far.

On the fiscal front, we commend the authorities for the track record of fiscal surpluses they have established over the past years, which allowed the accumulation of fiscal reserves that are proving crucial for the country's financial stability, especially in the context of the ongoing global financial crisis. However, large structural expenditures increases in the last years, notably in the wage bill and pensions, have led to considerable structural deficit in 2008, leaving little room for countercyclical policy. Hence, we agree that the measures incorporated in the 2009 budget constitute a first step towards controlling the deficit, including the freezing of the wage bill at the 2008 level for 2009-10. We also welcome the authorities' intention to make further expenditure cuts, notably in defense and investments, so as to keep the deficit within the 3 percent of GDP Maastricht ceiling. However, given the need for the country to boost growth in the near-term, we would appreciate staff elaboration on the type of investments for which the authorities are planning to make further cuts. Shouldn't it be appropriate for the authorities to consider a time phasing of the investments rather than cutting them?

In the area of fiscal transparency, we commend Estonia for meeting nearly all of the requirements of the Code of Good Practices on Fiscal Transparency and encourage them to focus efforts on improving budgetary planning and control over subnational borrowing.

Regarding the monetary and financial issues, we concur with the view that the currency board arrangement (CBA) has continued to serve the country well in keeping the inflation expectations low. However, in light of mounting internal and external imbalances, the authorities are well advised to remain vigilant and to continue enhance the credibility of the CBA, notably through prudent fiscal policies and flexible product and labor markets. The Estonian's banking system appears sound and well supervised. Nevertheless, the sector is subject to vulnerabilities stemming especially from Euro-denominated real estates lending and the dependence on short term external funding. In light of these exposures, we concur with the recommendation aimed at strengthening the financial safety net. We also welcome the authorities' implementation of recommendations of the February 2008 FSAP-Update mission, notably the increase in the insurance ceiling, the development of a plan for ELA in case of need, the preparation of the draft legislation to accelerate access to budgetary resources in the event of a financial crisis and the drafting of a legislation for a more flexible bank resolution framework.

On structural issues, we take good note of the authorities' recognition that continued product and labor market flexibility remains necessary. We welcome their commitment to increase labor market flexibility, as evidenced by the recent approval of a new labor market legislation, which will become effective in mid-2009. This new legislation, which is expected to reduce lay-off costs, align labor law with private contract law, streamline procedures and simplify conflict resolution, goes in the right direction.

With these remarks, we wish the authorities every success in their future endeavors.

Mr. Stein and Mr. von Stenglin submitted the following statement:

We thank staff for an interesting and concise set of papers, and Mr. Henriksson and Ms. Leemets for their insightful statement.

The Estonian economy has entered into a severe macroeconomic downturn. Following a period of very rapid economic expansion related to high credit growth and macroeconomic policies that fueled domestic consumption and a housing boom, significant external and internal imbalances had been built up that contributed to a wage-price spiral leading to worsening cost competitiveness. Propelled by the fallout from the global financial crisis, the current recession is likely to deepen in 2009. In the wake of this development convergence to EU income levels is set to suffer a pronounced setback. However, the present decline in economic output has precipitated a welcome easing of macroeconomic imbalances, thereby providing the opportunity for more sustainable output growth in the future. Continued progress toward fulfilling the EMU convergence criteria will have to be the authorities' top priority. Like staff, we fully support the authorities' signaling their continued commitment to the goal of euro adoption. As inflation is projected to come down markedly in the face of the downturn, the preservation of sound fiscal balances will prove the biggest challenge for the authorities going forward.

Fiscal Policy

In line with staff, we encourage the authorities to commit to the strict containment of the public deficit. Estonia's fiscal policy has been overall sound by the prudent accumulation of fiscal reserves in recent

years. Yet, given the constraints of monetary policy, an even tighter fiscal stance in the past could have done more to counter the overheating tendencies of the economy and to correct macroeconomic imbalances. Fiscal discipline has weakened in 2007-08, as large expenditure increases precipitated a growing structural deficit. As the cyclical position of the economy deteriorated, a significant deficit has now emerged. Given this development as well as the presence of marked downside risks to the near-term economic outlook, we underline staff's call for corrective measures.

Judging from the measures taken under the 2009 budget, the authorities are already making significant efforts towards keeping the deficit in line with the Maastricht-criterion. We commend the authorities in taking substantial structural measures to improve the fiscal position, notably the freezing of the wage bill and postponement of planned tax cuts. Moreover, we understand that the authorities intend to pare back a considerable pension increase initially planned for April 2009. However, further strengthening the medium-term budgetary planning remains an important issue, as it would mitigate the impact of poor revenue on public finances at the current stage and help to avoid the persistence of a structural deficit in the next growth phase. In recent years, expenditure targets put forward in the medium-term budget strategy have often been revised upwards when preparing the respective next year budgets. Following the updated Convergence Program submitted by the Estonian authorities in early December, more recently-announced measures aim at keeping the general government deficit below 3 percent of GDP. The expenditure cuts, which include a reduction of the public sector wage bill, are intended to support the adjustment process and strengthen the competitiveness of the economy. This is a welcome development underpinning the government's commitment to medium term consolidation.

Competitiveness and Labor Market

Given the constrained scope for public resources and the low fiscal multiplier, we fully agree with staff that a strong market-driven response is needed to emerge from the economic downturn. In this respect the Estonian economy is already well-positioned owing to its liberal institutions, flexible labor market, and level of international competitiveness. The currency board arrangement (CBA) continues to serve the country well. It has allowed for the adjustment process to take place in a relatively orderly fashion, yet it makes very high

demands on the continued flexibility of Estonia's labor and product markets. In order to reduce risks of monopolist-behavior driven price pressures, further efforts to minimize distortions on free competition are important, in particular in the utilities sector.

Wage adjustment is important in restoring cost competitiveness following several years of wage growth above productivity growth. The new labor law will further facilitate the adjustment of the economy to the changing environment, however close monitoring of wage developments is warranted, in particular as the new law remains yet untested.

In a strategic perspective a return to sustainable growth in Estonia would be facilitated by a shift of resources from the non-tradable to the tradable sector. Buoyant domestic demand and benign global financing conditions have been drivers of trade and current account deficits in recent years beyond a sustainable catching-up process. In the future, structural policies under the Lisbon strategy could be further enhanced in order to improve Estonia's export expansion which lagged behind developments in most other new EU member states since end-2006. On a more technical point, we take note that, according to the staff, Estonia's real exchange rate exhibits a mild overvaluation. Could staff provide further comments in view of Estonia's past export performance and integration in world trade.

Financial Sector

While Estonia's banks have so far weathered the effects of the financial crisis, the highly concentrated sector is subject to considerable vulnerabilities on both sides of banks' balance sheets. Following years of abundant external financing facilitating high rates of credit growth, banks have built up substantial exposures to households and corporates. The rise in NPL-ratios, which will be further accelerated by a continued correction in real estate prices, will increasingly weigh on banks' capital buffers going forward. At the same time, maturity mismatches have given rise to liquidity risks, as continued financial support from foreign parent banks – themselves reliant on the wholesale market – is crucial. In this regard, the declared willingness of foreign banks to support their operations in Estonia is reassuring. However, continued and close cooperation between home and host supervisors remain important.

Given this development, we appreciate the FSAP Update mission undertaken by the staff and underline the recommendations outlined in its FSSA for addressing existing weaknesses. The framework currently being prepared for providing emergency liquidity assistance to troubled banks is a welcome step to buttress the stability of the banking system.

Mr. Bakker and Mr. Tanasescu submitted the following statement:

Macroeconomic Outlook

Years of robust growth with comfortable fiscal positions underpinned the Estonian economy for most of the past years. However, as international conditions worsened, the economy stalled, reflecting mainly falling domestic demand and declining export growth. The outlook has worsened, with risks mainly on the downside. A deeper-than-expected recession in the Eurozone would slow exports and direct investment inflows further, and domestic demand is estimated to contract this year. This implies that the outcome could be worse.

In 2008 the size of international bank loan flows as a percentage of GDP has decreased sharply, with net FDI inflows taking over as the main source of financing for the external deficit. The outlook of a sharp fall in FDI to the region is expected to put severe financial strains on Estonia. A potential further threat is the relatively large share of short-term external debt of about 35 percent of GDP, that will have to be refinanced within a year. At the same time, the severe recession brought an abrupt adjustment of both external and domestic imbalances, which could be a factor in future recovery.

Fiscal Policy

We agree with Messrs. Stein's and von Stenglin's statement. We commend the Estonian authorities for the fiscal surpluses achieved over the past years. Nevertheless, it seems that public finances were not put on a sustainable footing during the boom years. As pointed out by staff, there is currently little room for counter-cyclical fiscal policy, in particular taking into account the limited availability of financing due to market risk aversion. The recent measures incorporated in the 2009 budget are welcome, but are only a first step towards controlling the fiscal deficit, and more efforts may need to be

implemented. We are encouraged that the government expressed being open to making further cuts, if needed, to keep the fiscal deficit within the Maastricht limit. In this context, we concur with staff that a significant medium-term fiscal adjustment is needed to consolidate the sustainability of public finances. Further wage moderation as well as shifting resources from non-tradable to tradable sectors would be welcome. Looking ahead a return to sustainable growth is contingent on securing competitiveness, while further labor market flexibility may contribute to for further fiscal consolidation. At the same time, we are encouraged by the recent approval of the new convergence program adopted on February 18, 2009 which reflects the Commission's recommendation on strengthening further the public finances and implementing prudent public policies to reinforce the medium-term budgetary framework.

Exchange Rate and Monetary Policies

The large current account deficit and high wage and price inflation made the real exchange rate appreciate too rapidly. However, the analysis finds that the real effective exchange rate of the Estonian kroon exhibits only mild overvaluation. In this context, we agree that erosion in competitiveness has been modest, but to keep the overvaluation under control within the currency board framework, the authorities should implement further fiscal and structural reforms, and speed up labor market reform. We agree with staff that the currency board system served Estonia well during the financial crisis, and was able to anchor expectations and protect the economy. We would like to stress the fact that it is important for Estonia's long-term economic sustainability to implement a sound policy framework, in line with the Maastricht criteria, prior to adopting the euro, and not to consider euro adoption as an option which would make the ongoing adjustment less necessary.

Financial Stability

The Estonian financial sector appears to have weathered the financial turbulence relatively well. So far this can be related to the relatively conservative reserve requirements and the improved supportive and regulatory policies. However, looking ahead, deteriorating asset quality and potentially reduced liquidity from the parent banks to their subsidiaries could pose significant challenges to the authorities. Until now these parent banks have supported their

Estonian subsidiaries during the financial crisis, but given the enduring pressures in the global financial markets and the adverse global economic developments parent institutions face increasing challenges in their domestic markets. The banks continue to be exposed to balance sheet risks, arising from considerable maturity mismatches of their long-term lending and short-term funds, and from high exposure to the real estate sector, which is in the midst of a steep contraction. This could lead to a significant rise of the proportion of bad loans and a deterioration of banks' asset portfolios. In this context, we agree with staff that these risks underscore the urgency of strengthening the financial sector contingency framework. Recently we saw the risk of financial contagion increase dramatically, which is illustrated by the deposit outflows at the Swedbank in Estonia. To avoid such adverse spill-over effects we encourage the authorities to intensify regional cooperation between home and host supervisor

Mr. Gibbs and Mr. Hills submitted the following statement:

We thank staff for a useful set of papers, and Mr. Henriksson and Ms Leemets for their helpful statement, and broadly associate ourselves with the comments of Mr. Stein and Mr. von Stenglin.

We broadly agree with staff's assessment of the challenges for Estonia's policymakers, although we differ slightly in emphasis on the question of how much fiscal space might be available for discretionary action should the macroeconomic situation deteriorate further, and would like to see further analysis of financial sector vulnerabilities, and spillovers to and from the other Baltic countries.

Fiscal Policy

We welcome the authorities' desire to run a responsible fiscal policy and to meet the Maastricht criteria, as embodied by the spending cuts in the recent supplementary budget, and we agree that fiscal policy could have been tighter over the past couple of years, given the very large output gap.

But, at the same time, Estonia ran fiscal surpluses for several years before 2008, has extremely low public debt, and is facing an estimated contraction in GDP of more than 6 percent in 2009. In this context, staff's comment that there is "little room for countercyclical measures" seems a little overstated. It seems to us that there could be

scope for discretionary fiscal action, if the macroeconomic position were to worsen further, as long as such a fiscal stimulus was well designed (most importantly, by excluding wage increases).

In terms of the authorities' moves towards medium-term sustainability, have Estonian policy-makers considered the use of fiscal rules to guide policy, beyond the Budget Law?

External Sector

The report contains some, albeit brief, coverage of spillovers from the Baltics and Nordic countries to Estonia. It would have been useful to see more detail on this (perhaps with some attempt to quantify the possible effects). Have the authorities indicated how they would react in the face of a sharper deterioration in neighboring countries? It would also have been useful to see some consideration of spillovers from Estonia to other countries within the Baltics, and the rest of Europe.

Financial Sector

We would like to see some additional analysis of the risks arising in the Estonian banking sector, given the extremely high dependence on (short-term) foreign bank funding, and very high proportion of foreign currency-denominated private sector exposures (as elaborated in the FSSA). In particular, the discussion in section III (C) of the Article IV report does not really address the interlinkages between the financial sector and the real economy. We would also like to see more analysis of tail risk scenarios.

The very high proportion of Estonian banks under foreign ownership could generate significant vulnerabilities. Although we welcome declarations of commitment from the parent banks, such as that made by Swedbank today, the willingness of parent banks to continue to support their Estonian subsidiaries does not guarantee their ability to do so. For instance, rating agencies have recently commented that they might downgrade European banks that have with large exposures to Central and Eastern Europe (in this respect, today's joint IFI action plan is most welcome). As usual in such circumstances, we stress the importance of close co-operation between home and host supervisors.

Structural Reforms

We agree with staff that a key medium-term policy challenge is to ensure the orderly re-allocation of resources towards the tradable sector (in which productivity growth has been very weak since 2000). We note that Estonia has already made good progress towards enhancing labor market flexibility, which should help to facilitate the reallocation of resources. Could staff please elaborate on the other policy steps taken in this respect?

Mr. He and Ms. Yang Jiehan submitted the following statement:

The Estonian economy, while it enjoyed fast growth over the past decade with increased integration into the EU, is facing a severe contraction with the deepening global crisis and economic recession. Recently, staff revised the projection of the 2009 GDP growth to -6.2 percent. Though inflation and the current account deficit will be reduced with the recession, liquidity and credit risks in the banking sector have risen considerably and so have pressures on the currency board arrangement. If global and regional conditions continue to deteriorate, what would be the extent of additional risk to growth and banking sector health? We do note, however, that with the authorities' past prudent fiscal policy and continued structural reforms, the sizable fiscal reserves and the relatively flexible product and labor market could provide some buffers.

As a small and open economy, the currency board arrangement (CBA) has served Estonia well. The authorities remain strongly committed to supporting the CBA with the euro adoption as the pillar of their policy framework. As the CBA is confronting heavy pressure from the global turbulence, if it does not ease up, could the process of euro adoption be accelerated if Estonia's fiscal deficit and inflation meet the Maastricht criteria at the end of 2009?

Fiscal policy plays a pivotal role in addressing external shocks in an economy with fixed exchange rates. As highlighted by Mr. Henriksson and Ms. Leemets in their insightful statement, maintaining long-term fiscal sustainability continues to top the authorities' agenda. It is regrettable that due to the recession, the budget ran into deficit in 2008 after achieving a surplus for the last six years. We welcome the authorities' strong commitment to taking the necessary measures to keep the deficit within the Maastricht limit. It is

encouraging to note that a supplementary budget for 2009 was recently approved when the recession turned out to be deeper than expected.

With the authorities' decisive response, the banking sector has so far weathered the financial turmoil well. Nevertheless, after a credit boom and due to Estonia's heavy reliance on external financing, liquidity and credit risks have been significantly heightened by the global crisis. Continued support from foreign parent banks is undoubtedly crucial for preserving the stability of the financial sector. We therefore commend the authorities for their strengthened coordination with host countries. We also welcome their intention to develop additional toolkits to strengthen the capacity of crisis management and to follow the FSSA recommendations to address existing weaknesses in the sector.

The real wage increase, which exceeded productivity growth in the past few years has slowed recently and contributed to the efforts of rebalancing domestic demand. Nevertheless, like staff, we agree that more can be done in increasing the labor market's flexibility to strengthen the country's capacity to tackle economic shocks with a fixed exchange rate regime. We welcome the recent adoption of a new labor contract law as it is much needed to facilitate adjustment in a severe recession by reducing labor market rigidities and improving the social safety net.

Mr. Warjiyo and Mr. Waqabaca submitted the following statement:

We welcome this opportunity to discuss Estonia, which has unfortunately been held up by the Fund's unnecessary internal angst, even though staff characterized the relations between Estonia and the Fund have been "excellent." The authorities would have probably been better served by earlier input on policy issues, many of which pre-date the crisis. The delay has had the unwanted effect of leaving the authorities on their own in coping with the current difficulties. In this context, we commend staff for keeping lines of communication open with the authorities and thank them for the well-written papers. We also thank Mr. Henriksson and Ms. Leemets for their helpful statement.

The authorities are to be commended for the sound macroeconomic performance attained, which has been grounded on market-oriented policies and a strong commitment to macroeconomic

stability. We welcome staff's assessment of strong implementation of previous Fund policy advice in Box 1. We were surprised, however, not to have at least some summary of the key recommendations as this would have been useful in allowing the Board to see what the staff saw as key policy issues that needed addressing, and whether those were indeed the issues that turned out to be important.

Looking ahead, Estonia now faces a severe recession as financing conditions tighten and demand in its key export markets weaken. The period ahead will be challenging with policy adjustments to ensure fiscal prudence, financial sector resilience and labor market flexibility necessary to anchor macroeconomic stability.
Mr. Henriksson and Ms. Leemets' statement informs us that the authorities are aware of the challenges, and view the current environment as providing an opportunity to step up the restructuring process to ensure sustained growth in the medium term.

External Stability

We note the contraction in the current account deficit, though this comes at a heavy cost in the shape of a sharp contraction in domestic demand. Estonia's credit-driven boom more than overwhelmed what had generally been a very prudent fiscal policy stance and de-leveraging is proving to be painful process. Having said that, we note that, at least in ULC terms, the real exchange rate continues to appreciate. We assume that this is due to the relatively high inflation seen until end-2008, though going by Mr. Henriksson and Ms. Leemets' statement, this trend is rapidly reversing itself. Indeed, the authorities expect, and probably rightly, that asset price declines and real wage cuts will fuel negative inflation by end-2009[1]. This should, therefore, drive a real depreciation of the kroon going forward, which supports the authorities' expectation of a speedier adjustment in external balances than staff project. Did staff take these possible trends into account when assessing external stability?

The key to exiting from these challenging conditions appears to be consumer and factor price adjustments, while maintaining confidence in the currency board. Indeed, the authorities see a credible

[1] We recall that in the latest special issues paper on India (SM/09/27, 1/26/2009), it was clearly demonstrated that there are significant non-linearities in the pass through from exchange rate depreciations to domestic prices to when domestic demand is impaired. In the case of Estonia, this might imply more significant disinflation in view of the currency board arrangement in place.

CBA as the key to eventual Euro adoption as their best exit strategy. We expect that this approach, while challenging, could indeed prove an important way of building political commitment to on-going reforms in difficult circumstances. The credibility of the CBA also underpins how one assesses risks to other parts of the economy, most notably the financial sector. What is the authorities' view on the timetable to eventual Euro adoption, and how likely is this expectation?

Fiscal Policy

Past years of prudent management and surpluses has strengthened Estonia's fiscal position. We regret that some loosening in wage restraint in recent years was seen in recent years, but are reassured by Mr. Henriksson's and Ms. Leemets's statement that the authorities' long-term fiscal sustainability is not threatened. In this respect, the government's intention to freeze the state budget wage bill for 2009-10 is a welcome development. Having said this, we note that this has been achieved partly by reducing headcount in the civil service rather than relying on wage rate restraint. We invite staff's elaboration on the potential impact on unemployment and domestic demand of this approach as opposed to one that targeted wage rate restraint. We also welcome the authorities' willingness to make further cuts to expenditure now, as well as the planned fiscal adjustment measures on wages and income tax to ensure medium-term fiscal consolidation.

Financial Sector

The Estonian financial sector continues to benefit from parent support in the face of sharply higher credit and valuation risks, lower income prospects going forward and substantial uncertainty on the funding side of the balance sheet. In this respect, we commend the enlightened attitude of the Swedish authorities for not resorting to financial protectionism and allowing their liquidity support to ensure the viability of their banks in the Baltics. Having said that, the funding model these banks use, which still show a substantial reliance on the wholesale markets, is a risky one. Obviously, this cannot be addressed during a crisis but it should be on the minds of both the Estonian and other Nordic regulators going forward.

In any event we welcome the assessment that Estonian banks remain well-capitalized, though we note that a substantial part of this comes from a reduction in the risk weight to real estate lending. How does the new capital charge rate compare with the rates in Sweden and the other home jurisdictions of Estonian banks? On one hand, we see the source of staff's discomfort with the change in the guidance at this time (though such a move is very much in line with the Basel II guidelines). On the other, we can see the authorities' point of view in that this reduction is very prudent in the context of the guidelines, and could help banks' asset and liquidity management by tying up a smaller portion of their funds in capital. The bigger issue for us and the international community is probably the universal appropriateness of the Basel Committee's guidelines, which are primarily based the recent experience of a small number of advanced economies, to emerging markets. There may need to be a re-think of the advice that goes along with these guidelines so that individual regulators can make an assessment on how these rules could be tailored to their unique conditions.

As staff had noted, there is no direct foreign exchange risk to Estonian banks but the unhedged forex liabilities of borrowers will see any depreciation affect balance sheets through the credit and valuation channels. In view of how large these vulnerabilities have become (nearly 80 percent of GDP), we wonder what prudential options were there to limit this explosive growth in unhedged borrowing. Staff elaboration would be appreciated.

Labor Market Reforms and the Social Safety Net

We take note of staff's assessment that the overall flexibility of the Estonian labor market will be an asset in adjusting to this crisis. We commend the authorities on their very impressive reforms in recent years that have placed them in this position of strength. The new legislation that will come into effect later this year is a testament to the authorities' willingness to take hard decisions to further these reforms. Having said that, we found staff's concern regarding the corollary to this flexibility, better safety nets, somewhat difficult to accept. We agree the costs of any support needs to be carefully accounted for and the means of support should not create distortions. Nonetheless, Estonian households and workers carry unenviable levels of risk: exchange rate risk, employment risk, and income risk. We imagine that not providing adequate safety nets would have made the

additional reform measures harder to get through. In this context, we think the appropriate counterfactual would have been: What would have been the outcome of a cost-benefit analysis between this package and no package at all? Staff comments would be welcome.

Looking ahead, we hope the Fund will stand strongly behind Estonia in these difficult times. With these remarks, we wish the authorities well in their endeavors.

Mr. Alazzaz submitted the following statement:

I thank the staff for a well-written set of papers and Mr. Henriksson and Ms. Leemets for their helpful statement. The Estonian economy is experiencing its most severe recession since the early 1990s. However, the economy has entered into this downturn from a relative position of strength after undergoing a major transformation over the past decade. Indeed, Estonia weathered well the severe financial shocks in 2008, including in the face of problems in Latvia, and the banking sector appears to be sound and well supervised. Moreover, the currency board arrangement (CBA) is functioning well and government's considerable net asset position provides additional comfort. The challenge now is to maintain financial stability and take advantage of the economy's flexibility to facilitate a recovery.

On the fiscal front, the authorities are to be commended for building a net asset position by sustained fiscal prudence. However, the staff notes that large structural expenditure increases pushed the fiscal balance into deficit in 2008. In this regard, I welcome the steps taken in the 2009 budget towards controlling the deficit and the willingness to take additional measures for the 2010 budget so as to limit the draw-down of the government assets. These efforts are also important to keep the deficit within the Maastricht limit. It is also reassuring to note the authorities' commitment to fiscal balance or surpluses over the medium term.

The CBA continues to serve the economy well. Indeed, I am reassured to note that the CBA did not come under significant pressure during the financial crisis, given the robustness in design, and the support of the fiscal reserves and a sound banking sector. Regarding Euro adoption, I welcome the authorities' intention to move in that direction as soon as possible.

On financial sector policies, it is reassuring to note the findings of the FSAP update about the soundness of the banking sector that has shown particular strength in asset quality and earnings. It is also encouraging that there are no serious weaknesses in bank supervision and regulation. That said, given the current unsettled external environment, the banking sector is subject to a number of vulnerabilities from euro-denominated real estate lending and the dependence on short-term foreign borrowing from parent banks. In this regard, I welcome the steps taken by the authorities as mentioned in paragraph 23 of the staff report and look forward to the planned measures to further enhance the resilience of the financial sector.

Finally, sustained efforts on the structural reform front have helped in creating flexible labor and product markets. In this regard, the recent move to further increase labor market flexibility while strengthening the social safety net is a step in the right direction.

With these remarks, I wish the authorities further success.

Mr. Prader and Mr. Jakoby submitted the following statement:

We thank staff for the informative and well-written set of papers and Mr. Henriksson and Ms. Leemets for their insightful statement. We broadly share the staff's analysis and would like to make the following points for emphasis.

Like its regional peers, Estonia has not been able to escape the economic and financial crisis and faces a strong decline in output. However, there is a good chance that Estonia could weather this storm in relatively better shape thanks to its flexible product and labor markets. The currency board arrangement has remained credible and resilient to the financial turmoil while the very low public debt provides a welcome cushion and should provide confidence to investors. The credibility of the euro adoption as a strategic goal and maintaining the confidence in the currency board remain key anchors of a successful recovery.

While for most of 2008, Estonia's exports were somewhat resilient to the falling external demand, they were strongly hit at the end of the year. The prospects for recovery of growth in 2010 will to a large extent depend on the revival in the key export markets.

The economic downturn has led to the substantial reduction in external imbalance and alleviation of inflationary pressures. However, to sustain this positive trend, we join Messrs. Stein and von Stenglin in urging the authorities to address the remaining competition distortions in the utilities sector. To protect cost competitiveness, it is crucial to contain the recent excessive wage growth and ensure that it corresponds to productivity growth. The recently adopted Labor Law should be helpful in achieving this goal.

The regrettable large fiscal loosening in 2007, and even more so in 2008, reflected in the 3 percentage point increase in the cyclically-adjusted deficit, is seriously limiting the room for countercyclical fiscal stimulus in 2009 in the context of the planned euro adoption. Nonetheless, the authorities deserve credit for the fiscal restraint incorporated in the 2009 supplementary budget, in particular, the freezing of the public wage bill and reduction in operational expenses, adopted amidst the severe decline in economic activity. Their commitment to further measures if necessary, in order to remain on the path for meeting the Maastricht fiscal criterion is encouraging, although it may be put to a test if the fall in economic activity proves more severe. We note that the increase in EU transfers in 2009 will provide some compensation for the stagnating tax revenue. With regard to financing, the authorities have some room to maneuver because of the liquidity buffer accumulated thanks to the past fiscal surpluses.

While the banking sector soundness indicators remain solid, the balance sheets are vulnerable due to the large share of foreign exchange-denominated loans as well as the high dependency on short-term financing from parent banks. We note with some concern that the maturity mismatch in the financial sector balance sheets deepened considerably in 2008. In this regard, the commitment of parent banks to long-term strategic presence in Estonia is reassuring. We also welcome the recently developed framework for emergency liquidity assistance for large banks and the access to fiscal resources during a crisis.

Ms. Xafa submitted the following statement:

We thank staff for the well-written set of papers and Mr. Henriksson and Ms. Leemets for their informative statement.

Estonia, a star reformer, has been severely affected by the global crisis through both financial and real channels—sharply lower external credit flows and falling global demand. We share the points raised by Mr. Stein and Mr. von Stenglin and have only a few additional remarks.

The supplementary budget for 2009 just approved by Parliament is expected to reduce the general government deficit to about 1 percent of GDP. Presumably this would represent a structural surplus, given the projected 6.2 percent contraction in real GDP. We take positive note of the authorities' objective, stated in the Staff Supplement, to ensure that the deficit would not exceed the 3 percent Maastricht limit even if GDP falls as much as 8 percent in 2009. Their willingness to cut budgetary spending in the midst of a severe recession is testament to the priority they attach to meeting the EMU convergence criteria as soon as possible, as the Euro would provide "a safer heaven" compared to the currency board. Given the country's long-standing membership in ERM-2, negligible gross public debt, and the sharp decline in inflation expected in 2009, what is the sticky point in Euro adoption?

The financial system has weathered relatively well the global financial crisis despite the country's heavy dependence on short-term external funding sources. Exchange rate stability, large capital buffers, strengthened financial safety nets, and the long-term, "strategic" nature of the presence of Nordic banks operating in Estonia have contributed importantly to financial stability. We welcome the apparently seamless coordination between the host and home countries in securing a continued flow of credit, as well as the authorities' prompt implementation of FSSA recommendations (Box 4). However, we are puzzled by the recommendation to implement a lender-of-last-resort capability, as this could undermine the operation of the currency board. Could staff please elaborate on how this facility would operate?

We share the skepticism of staff and authorities regarding the reliability of CGER estimates in an economy undergoing rapid structural change. The information presented in Figure 7 (p. 10) does not suggest any significant overvaluation or loss of market shares. Nevertheless, recovery from recession would be aided by competitiveness gains through further wage moderation. We welcome the recent adoption of a new labor market legislation, effective in mid-2009, which will eliminate the few remaining labor market rigidities

while strengthening the social safety net. Estonia's labor and product markets are already quite flexible and competitive, so we are confident that the economy will rebound strongly once the global turbulence subsides.

Mr. Fayolle submitted the following statement:

We thank staff for an interesting set of papers, as well as Mr. Henriksson and Ms. Leemets for their informative statement. We share the views expressed by Messrs. Stein and von Stenglin and will therefore limit ourselves to the following comments.

Several years of strong growth above potential have led to the build up of sizable external and internal imbalances among which important current account deficits and inflation, along with a housing bubble. The global financial crisis has dragged the country into a hard landing with a contraction of GDP which could reach 6.2 percent of GDP in 2009. Since it entered in recession last year, Estonia has nevertheless shown the flexibility of its economy, as highlighted by the fast and significant reduction of its current account and inflation. Despite these positive factors, significant risks are still weighing on the country: the amount of its external debt, its dependence to foreign financing and its dependence to potential spillovers effects from neighbor countries. The crisis is a test for the policy framework based on a currency board supported by sound fiscal positions and flexible labor and product markets.

We welcome the authorities' commitment to contain the public deficit under 3 percent of GDP, as set up by the Maastricht treaty. After years of sound fiscal policies which have led to surpluses accumulated as reserves, expenditures have risen beyond reasonable levels in the last two years and the country experienced a fiscal deficit for the first time in 2008. Given the size of the recession and its impact on fiscal revenues, the authorities have right taken important steps to limit the deficit, such as the overall reduction of public wages bill, and a delay of planned tax cuts and pension increases. These measures should be sufficient to meet the authorities' objective provided no further expenditure are added to the budget. The authorities' fiscal discipline and the reserves accumulated allowing the deficit to be financed without the need for accessing the markets are strong buffers for the economy. This should help maintain confidence in the currency

board arrangement, which remains the cornerstone of the policy framework.

Under the policy framework, we agree with staff that the economy will have to further prove its flexibility to restore the country's competitiveness. We note that the country's exchange rate appears to be slightly overvalued Structural measure aiming at further improving flexibility of labor and products markets, and at boosting productivity growth in the tradable sector would ensure the orderly re-allocation of resources towards the tradable sector. In this regard, we welcome the recent labor law which should be effective by mid-2009.

The financial sector has proven quite resilient so far, but risks are significant. The banking sector is highly integrated with the Nordic countries and local branches and subsidiaries have therefore benefited from guarantees granted by home countries' governments to their banks. This has been an important stabilizing factor. Nevertheless, several risks need to be pointed out. First, the share of non-performing loans will continue to increase due to the economic recession and the decrease in housing prices. Second, long term loans of banks are overall funded by short-term loans, which opens a liquidity risk that will need to be closely monitored. We are reassured by the commitment of the Nordic banks to maintain their activity in the country, thus limiting the materialization of a liquidity shock.

Ms. Lundsager and Mr. Lin submitted the following statement:

While Estonia's economy is experiencing a difficult recession, its prudent policies have thus far supported an orderly adjustment of external imbalances. Nevertheless, the economy remains vulnerable to a disruption of external funding. The key challenges are to maintain confidence in the currency and the banking system, which will require continued strong engagement with neighboring central banks and supervisory authorities. We welcome the Estonian and Nordic authorities' strong efforts to overcome these challenges, and we support the staff's key recommendations for further policy action.

Currency Regime and External Stability

While Estonia's strong public balance sheet anchors the credibility of its currency board, the economy may now be paying a price for not being among the first new EU entrants to join the euro

zone. The nominal exchange rate is inflexible, yet still subject to concerns about devaluation as currencies throughout the region come under pressure. Risks to bank funding are elevated, yet access to emergency liquidity assistance is constrained. Meanwhile, potential for negative feedback between currency pressures and banking sector stress has grown, as household and firm balance sheets have grown vulnerable to an exchange rate adjustment, and as the banking system's short-term liabilities have grown large relative to the central bank's liquid assets. We understand the current rules for accession to the euro. Against this backdrop of current conditions, however, we invite the staff to assess the advantages and disadvantages of early adoption of the euro by Estonia.

Based on the staff's analysis of external stability, the real exchange rate appears modestly overvalued, though there is some uncertainty about magnitudes. We commend the staff for its exemplary documentation of this assessment, particularly the transparent presentation of results and key assumptions.

Financial Sector

The banking system has weathered turbulence relatively well thus far, partly thanks to the commendable improvements in financial sector supervision in recent years. Nevertheless, the system is vulnerable to a disruption of wholesale or deposit funding, as well as rising NPLs, given the heavy concentration of real estate-related loans to borrowers who have not hedged the associated foreign exchange and interest rate risk.

We encourage the authorities to accelerate preparations for potential liquidity or solvency difficulties in the banking system, in cooperation with regional authorities. Commendably, the authorities have already implemented a number of related FSAP recommendations, but some important preparations to handle potential capital adequacy issues at large banks are not yet finished. We agree that a fuller range of bank resolution practices should be enabled, and that deposit insurance funds should be available to facilitate resolution techniques besides liquidation.

Given the dominant role of Nordic banking groups that are themselves under pressure, we commend the authorities' emphasis on cooperation with the home authorities, as explained in the statement by

Mr. Henriksson and Ms. Leemets. Noting the results of the stress tests, we invite the staff to assess regional as well as domestic preparations, such as cross-border burden sharing agreements, to address potential capital adequacy issues at multinational banks active in Estonia.

Fiscal Policy

Fiscal policy must remain supportive of the currency board and euro adoption. Given the recent deterioration of the structural fiscal balance and the euro area authorities' current policies regarding euro zone accession, this requires a very severe procyclical tightening of fiscal policies. We commend the authorities for taking difficult steps to bring the 2009 budget within the Maastricht deficit limit, especially the significant and timely expenditure cuts in the supplementary 2009 budget. Does the staff's analysis confirm that these measures will reduce the deficit well below the Maastricht limit under the authorities' latest baseline forecast?

Mr. Pereira and Mr. Maciel submitted the following statement:

According to the staff report, fiscal expenditure in 2008 went up as consequence of large wage and pension increases that were translated into fiscal deficits. Given the rapid pace of fiscal deterioration augmented by the drop in domestic demand due to the recession, the authorities responded by front-loading the adjustments to recover fiscal discipline in the short term, bringing the deficit into the boundaries of Maastricht's ceiling. Although we welcome their commitment to decrease the fiscal deficit to reach an early Euro adoption, we wonder how realistic is to continue pressing for additional measures in the 2009 budget. The hard measures already included in the budget leave little room for further cuts. On the contrary, under the current scenario there will be calls for additional expenses on social safety programs and the like. Indeed, the recently adopted Employment Contract Law increases the unemployment benefits and the number of beneficiaries. Could the staff elaborate on the size and scope of current social safety net programs?

We are of the view that more wage moderation could lead to increased recession and social and political unrest, as we have seen recently in neighboring counties and other European economies. We are puzzled to see that labor market flexibility continues to be envisaged as the first line of defense in the context of this crisis. The

staff mentions that nominal wage growth slowed down in 2008, but they are still below EU levels. Considering that real wages are still converging to EU levels, the policy advice of further salaries cuts is not compatible with reality. According to Box 3 of the staff report, Estonia's labor market is among the most flexible in the EU region, which is also highlighted by Mr. Henriksson and Ms. Leemets in their statement. Therefore, reallocating resources from low-wage to value-added activities would reap much greater benefits than keeping down wages. We stress that these facts should be strongly considered by the staff before insisting on wage moderation and strongly disagree that shifting the burden of the crisis onto the working class is the best approach to deal with it.

The global financial turmoil and the current recession are putting pressure on the Estonian financial system. Although the sector has showed resilience to weather these problems, there are signs of deterioration in some core indicators, such as the strong increase in non-performing loans, which is expected to grow even further in 2009. In addition to the deterioration of credit quality, the meltdown of the real estate market is also raising concerns of liquidity problems and foreign currency vulnerabilities, since much of the banking long-term housing financing has been funded by short-term foreign borrowing. Given these facts, it is of the utmost importance to follow the recommendations of the FSSA report, which provides a useful set of principles and actions needed to strengthen the financial safety net. In this regard, we commend the authorities' decision to implement some of the key proposals, notably the strengthening of the deposit guarantee scheme, the plan to provide emergency liquidity assistance to banks in the event of financial crisis and the strengthening of the supervisory body. We look forward to the prompt approval of legislation that would entail a more flexible bank resolution framework.

Finally, on cross-country collaboration, we are pleased to acknowledge the signing of a wide range of Memoranda of Understanding among domestic supervisory agencies and their foreign counterparties, as well as the commitment to conduct a joint Baltic-Swedish crisis simulation exercise involving a large Estonian Bank. Considering that four Nordic group banks comprise 95 percent of the Estonian banking system, these actions will certainly enhance the crisis management capabilities of the authorities.

With these remarks, we wish the authorities continued success in their future endeavors.

Mr. Guerra and Ms. Mira submitted the following statement:

We would like to thank staff for a very useful and comprehensive set of papers, and Mr. Henriksson and Ms. Leemets for their insightful statement.

After a period of impressive growth, and the implementation of liberalization and flexibility enhancing measures, Estonia, as a small open economy, is currently being affected by the international crisis. The reduction of bank credit and the fall in asset prices (housing included) has resulted in a substantial contraction of domestic demand and thus growth. While these dynamics have contributed to the reduction of the external and internal imbalances that had accumulated during the boom, they have also led to a severe contraction and posed significant challenges for the country. We share Mr. Stein's and Mr. von Stenglin's views, so we will just add the following comments:

The currency board arrangement has served the country well, and has repeatedly proved its resilience. It is contributing to paving the way for Euro adoption, which should take place as soon as possible once the adjustments required by the Maastricht criteria have taken place. On the fiscal side, we welcome the authorities' envisaged restrictive fiscal stance that focuses on ensuring credibility and long-term fiscal sustainability.

As a very open and small economy, which is almost entirely dependant on foreign financing, Estonia is influenced by regional developments. In that sense, we would have liked, like Mr. Gibbs and Mr. Hills, to see further detail in the analysis of the regional spillovers from the neighboring Baltics and Nordic countries. We also welcome today's announcement of the joint IFIs Action Plan to support Central and Eastern Europe, and would like to hear staff's views on its possible impact on Estonia.

On the financial sector, the FSAP found a sound, well-capitalized and resilient banking sector, although with high exposure to risks and vulnerabilities. While large buffers and adequate policies provide some reassurance, they can also rapidly be eroded during the recession. So far the system has weathered the global credit crunch well, but the situation going forward is more uncertain. Therefore, we welcome the authorities' actions to implement the FSAP Update recommendation to strengthen the financial safety net. Cross-border cooperation, which has been reportedly good in the last years, should also continue.

On cross-border cooperation, the latest Art. IV highlighted the institutionalization of such cooperation as a positive feature. However, the current report acknowledges in paragraph 32 that the routine cooperation and exchange of information by supervisors was more important than the existence of formal agreements. Are there any lessons that could be drawn in this regard from other cases?

On the structural front, we concur that wage adjustments are critical to improve cost competitiveness. Thus, we support efforts to further enhance the already flexible labor markets, and in this sense we welcome the new Employment Contract Law. At the same time, we expect that the social safety net adequately protects the most vulnerable social sectors. We are reassured to learn that the new law also increases unemployment benefit rates and enhances security.

With these remarks, we wish the authorities success in their endeavors.

Mr. Yamaoka and Ms. Shinagawa submitted the following statement:

We thank the staff for their informative report and Mr. Henriksson and Ms. Leemets for their helpful statement.

Macroeconomic Policies

Estonia is undoubtedly in a challenging situation, facing severe external imbalances stemming from the global recession, intensified risks in the financial sector, and a decline in international reserves under its currency board regime. Under these circumstances, it is critical to examine what effective mechanisms could stabilize the nation's economy against downward shocks.

Although the currency board regime may work as an effective nominal anchor, from the viewpoint of basic economic theory, it would inherently impose constraints on macroeconomic policy conduct, as follows:

When the nation's exchange rate is overvalued on a real effective basis under the currency board regime, the necessary adjustments will take place through negative inflation and a decline in nominal wages. (Although productivity growth could also be an adjustment force, it would be difficult to expect drastic productivity gains within a couple of quarters.) In this regard, what the nation's economy is experiencing, in terms of inflation and nominal wages, is almost in line with economic theories.

Under currency board regimes in which the maneuver of nominal interest rate controls is limited, deflationary pressures will inevitably raise real interest rates. High real interest rates will dampen domestic demand. (Needless to say, one of the options to compensate for declines in domestic demand is to increase fiscal expenditures by means of automatic stabilizers or adopting discretionary and counter-cyclical fiscal policy conducts. However, in Estonia, room for counter-cyclical fiscal measures is also limited.)

Under the mechanisms as described above, although the financial sector could weather well the initial shocks of the global financial turbulence, it is likely that downward pressures stemming from external factors will intensify the downturn of the real economy.

In addition, the above-mentioned adjustment process may not be without pains. (For example, although the enhanced flexibility of the labor market would enable the nation to maintain competitiveness through unit labor costs, it would lead to a decline in the nominal income of households.)

In this regard, we would like to encourage the authorities to remain vigilant against negative shocks, since the authorities' maneuvers of counter-cyclical macroeconomic policies are limited and it is difficult for them to expect very effective endogenous mechanisms to stabilize domestic demand. In addition, the prospects for global economic recovery are very uncertain.

Financial Sector

Although Estonia's banks have, so far, managed to cope with the global financial turmoil, the financial sector's potential risks warrant continuous vigilance. In particular, we cautiously note the risks on the balance sheets of financial institutions given the recent increase in the ratio of both non-performing loans and provisions. In this regard, we would welcome the staff's comments on the near-term prospects of non-performing loan ratios and provisions, as well as the potential risks for banks' loan portfolios.

We also note the large share of euro-denominated loans in bank lending portfolios, and would like to know the background of the economic entities' strong preference toward euro-denominated loans. (Indeed, if the authorities' commitment to euroization is very strong and the economic entities see the euro and the nation's currency as perfect substitutes, there would be no reason for a strong preference toward the euro.)

With these comments, we wish the authorities every success in their future endeavors.

Mr. Moser and Ms. Tartari submitted the following statement:

We welcome the authorities' strong commitment to fiscal consolidation, which is essential to strengthen fiscal sustainability. We wonder, however, whether the staff's revenue projections are realistic, given the sharper than expected decline of GDP over the last year. Staff's comments would be welcome. We would also like the staff to elaborate on the feasibility of reforms aiming at making the budget more flexible in the near term.

The currency board regime served Estonia well and indeed provided an anchor for macro policy. The track record of effective adjustments under the regime bodes well for the future and for swifter membership in the EMU. However, as the fiscal Maastricht criterion may become the biggest challenge to entry the EMU, further fiscal measures may be needed.

According to the staff, the Estonian financial system seems to be resilient. In our view, the parameters used in the stress tests might be on the optimistic side, and the latest data on GDP growth provide,

unfortunately, some evidence. Could the staff explain whether the results of macroeconomic stress test scenarios remain adequate in light of the larger than expected decline in GDP?

Finally, we note that the Estonian central bank has established a precautionary agreement with Sweden's Riksbank, which would allow to borrow Swedish kronor while shoring up markets' confidence. Could the staff elaborate whether this may be a model for countries with a currency board and a large share of foreign banks?

Ms. Agudelo and Mr. Maciá submitted the following statement:

We thank staff for an illustrative set of papers and Mr. Henriksson for his clear statement.

After several years of an outstanding economic growth, nowadays Estonia faces the strains of a bleak prospect with negative economic growth affecting the country since last year. As other countries in the region, Estonia did not escape building macroeconomic imbalances during the boom period, which put the country on a highly vulnerable foot to face the current global environment. Vast private capital influx fueled domestic consumption together with high wages, low interest rates, and high credit availability. On the positive side, government finances remained strong under a prudent fiscal policy. Estonia is also known as the fastest convergence country for EU membership.

At the moment of the last Article IV consultation in 2007, staff and Directors recommended a tight fiscal policy to offset the macroeconomic overheating and to reduce the pro-cyclical impulse originated by the new spending. Meanwhile, we note that today the room for active counter-cyclical fiscal policy is reduced under the current circumstances, and the burden of the adjustment is falling on private demand, making the adjustment more painful. Nominal wages growth has decreased while unemployment has increased. As economic activity has weakened, inflation and the external current account deficit are expected to come to single digit.

With the currency board arrangement and the constrained fiscal policy, the correction of the macroeconomic imbalances has to find financing to mitigate a disorderly unwinding of the imbalances. In that sense, we note a better than expected performance of exports and the

buffers provided by previous fiscal prudence. In the same vein, we concur with staff and the authorities that a key feature of the macroeconomic policies are flexible labor and product markets. We welcome Mr. Henriksson's assurance that the current circumstances might give support to speed up structural reforms.

A combination of tightened world liquidity and rising risks concerns by Nordic Banks brought about a loss of confidence that affected the banking sector. However, the financial sector has remained well capitalized and with enough reserves. In addition, strong support from Nordic parent banks and clear actions from the authorities providing liquidity and guarantees have given some assurances. In any case, banks face liquidity and credit risk exposure given their euro-denomination lending and floating rates, and long term mortgage lending with maturity mismatches. We note the strengthen supervision and cross-border coordination, and we welcome the emergency liquidity assistance (ELA) plan and the expected increase guarantee deposits as priority FSSA actions amongst others that should have enhanced the sector's resilience and confidence.

We want to express our concern on the overvaluation of the real exchange rate. In this regard, we note that staff measure the overvaluation at a range of 3 to 19 percent. We would like staff's candid opinion on the risks that this overvaluation of Estonia's currency might carry. In spite of a robust CBA, a net creditors position of the government, its low debt profile and the buffers in the banking sector, what risks to the peg and the CBA could emerge in the context of a deeper recession and a weaker financial system? We are also cognizant of the pressures on the fiscal stance for 2009 and 2010 given the existing budget constraints that affect present and medium-term efforts for fiscal consolidation which may influence delays in the euro adoption timetable. The staff's opinion is welcomed.

Mr. Daïri and Mr. Ghassemi submitted the following statement:

We thank staff for a set of well-written papers and Mr. Henriksson and Ms. Leemets for their helpful statement. Following several years of impressive growth and significant progress towards income convergence with advanced European countries, Estonia's economy is experiencing a rapid contraction stemming from the global crisis. The pattern of the foreign-funded boom and the subsequent economic downturn are similar to those experienced by

other countries in the Baltics and Eastern Europe. Nonetheless, we agree with Mr. Henriksson and Ms. Leemets that Estonia has entered the crisis from a position of strength, with strong fiscal and liquidity buffers, a sound and well-supervised banking system, and the EMU entry anchor. We broadly agree with staff analysis and policy recommendations.

While the sharp contraction in domestic demand has reduced imbalances, the near-term growth outlook remains uncertain and hinges on the recovery of investment and exports and the restoration of consumer confidence. This would be challenging given the weak export demand in regional markets and some erosion of Estonia's competitiveness due to past real exchange appreciation. We are assured by Mr. Henriksson and Ms. Leemets that there is evidence of labor market flexibility, which would be key to the adjustment process given the currency board arrangement (CBA). We agree with staff that the recent slowing of wage growth should be sustained and deepened.

Fiscal sustainability remains key in supporting the CBA and the anticipated euro adoption. Expenditure increases in recent years have led to a significant structural deficit, thereby reducing the room for countercyclical policies. Guided by the need to meet the Maastricht fiscal deficit criterion, while maintaining a cushion of fiscal reserves, the authorities have intensified the already difficult measures of the 2009 budget by further tightening in the recently approved supplementary budget. However, the authorities commendably recognize that the task over the medium term is challenging. We are pleased with their performance in fiscal transparency in response to the recent FAD mission recommendations.

We commend the authorities for the significant progress in financial sector supervision and the implementation of key FSAP recommendations. Banks have remained resilient, thus far, in the face of the global financial crisis. However, the full impact of the downturn may still lie ahead. Households and firms are exposed to significant foreign exchange risks from Euro-denominated bank loans, including long-term mortgages. These loans, and their funding by short-term foreign lending by parent banks, entail maturity mismatch and liquidity and credit risks. Moreover, with rising non-performing loans, albeit from a low level, and falling real estate prices, credit quality is deteriorating. We take comfort in staff indication that these vulnerabilities are mitigated by strong institutions and large buffers.

We note that the financial system needs to develop a safety net, including an expanded bank resolution framework. Given the highly concentrated financial system and the increased degree of integration, it is also important to enhance group-based cross-country coordination between host-home supervisory authorities, including routine exchange of information and region-wide crisis simulation exercise.

As highlighted by Mr. Henriksson and Ms. Leemets, CBA has served the economy as an anchor for stability, especially in anticipation of EMU entry in 2011. We note the authorities and staff's view that the estimates of the exchange rate overvaluation are not conclusive, and we are somewhat troubled by the widespread skepticism among country authorities about the value to be attached to real exchange rate calculations. This being said, close monitoring of external competitiveness, notably with regard to real wage developments, will be important.

The new labor market legislation is a step in the right direction and would enhance labor market flexibility while strengthening the safety net, as indicated by Mr. Henriksson and Ms. Leemets. We agree with staff that the fiscal costs of the safety net as well as possible adverse labor supply effects should be clearly assessed. We wish the authorities success in their endeavors.

Mr. Lushin and Mr. Tolstikov submitted the following statement:

We thank the staff for a set of high quality papers and Mr. Henriksson and Ms. Leemets for their informative statement.

The current crisis is the ultimate test for the Estonian economy: whether it will be able to resolve the imbalances accumulated in the recent years in an orderly manner or there will be a hard lending. The fate of Estonia is tightly linked with the regional as well as global developments – if Latvia abandons its currency peg or Nordic banks are unable to obtain sufficient financing in the international markets, the Estonian financial system and the economy will come under severe strain. Then the outcome would depend on the magnitude of a shock but also on the adequacy of "financial safety framework", including the size of buffers in the banking and fiscal systems, smooth functioning of the recently improved ELA framework and cooperation with major foreign creditors and their authorities.

In preparation for tough times, two tasks are the priority: maintaining tight fiscal stance and strengthening the resilience of the financial sector. On both fronts, the authorities' efforts are commendable and deserve full support.

Despite its sound fiscal position and unlike major advanced economies, Estonia has little, if any, space for countercyclical fiscal policy. Its fiscal policy should provide support for the currency board arrangement and for the goal of the ultimate euro adoption. Therefore, we commend the authorities' commitment to ensure that, even in case of a severe economic downturn, the deficit would not exceed the Maastricht limit. The adoption of a supplementary budget for 2009, envisaging further cuts in current expenditure, is a difficult but logical step in view of a deteriorating economic outlook. Public sector wage cuts would contain wage expectations in the private sector, reducing demand pressures and helping to restore the eroded international competitiveness. At the same time, preservation of the government's liquidity buffers is especially important for supporting confidence in Estonia's financial system.

Financial sector vulnerabilities is another priority for the authorities' attention. Banks have weathered the first round of financial shocks in 2008 relatively well, but remain vulnerable to real estate problems and disruptions in international financial markets. The credit quality is deteriorating as economic activity is slowing and profits and incomes are dropping. The ability of the Swedish banks' to support their Baltic subsidiaries is under increasing strain.

In this regard, we commend the authorities for their decisive strengthening of the financial safety net and improving the bank resolution framework. Strengthened coordination with Nordic countries' monetary and supervisory authorities becomes even more important. We urge the earliest adoption of a new draft legislation that facilitates the use of budgetary resources in financial crises. The development of a framework for providing emergency assistance to large banks is particularly important.

The staff assessment shows that the real exchange rate remains somewhat overvalued after several years of real appreciation. Therefore, to enhance competitiveness the authorities should continue improving labor market flexibility. The currency board arrangement served Estonia well and maintaining confidence in the CBA should be

among the main priorities. However, the staff appraisal notes that the euro would provide the safe haven. The euro adoption is also mentioned "as a clear exit strategy" (p.21). Could staff elaborate in greater detail when the euro adoption could be an exit strategy and under what circumstances?

The updated forecast, provided in the staff statement, suggests that GDP in 2009 will decline by 6.2 percent instead of 4 percent in the staff report. Even without this correction, the unemployment level was projected to double in 2009 in comparison with 2008. Although people in the region are accustomed to hardships, the full social impact of the crisis is yet to be felt. Therefore, despite the necessary budget austerity, we encourage the authorities' to step up efforts in improving the social safety net.

With this remarks, we wish the authorities success.

Mr. Horgan and Mr. Purves submitted the following statement:

We thank the staff for a comprehensive set of papers, and Mr. Henriksson and Ms. Leemets for their helpful statement. For more than a decade, Estonia recorded a commendable economic performance largely reflecting the authorities' consistent implementation of prudent macroeconomic policies. Estonia enjoyed rising incomes, a favorable investment climate, and low-interest financing that surged domestic demand. The economy evolved, facing capacity constraints which led to widening current account deficits, rising inflation and higher real wage growth.

The economic crisis we face continues to challenge many growth models, and Estonia is no exception. The fast convergence and exceptionally rapid increase in living standards in Estonia is inevitably accompanied by its own risks. The Estonian authorities have committed to moving towards euro adoption, which has guided its stance on maintaining its Currency Board Arrangement (CBA) and a relatively modest fiscal policy. The staff approve of this course, and it is from this perspective that we focus our remarks along the lines of exchange rate considerations; fiscal policy; and financial sector developments.

Exchange Rate Considerations

On external balances, at the core of the matter is the sustainability of the "stay-the-course" policy framework proposed by the Estonian authorities and supported by the staff. The CBA is viewed by both as having served Estonia well, and remains robust. Despite a possible overvaluation of the kroon at present, the range is wide (3 to 19 per cent) and authorities have made good points with respect to erring on the low side. Nevertheless, there are risks that the focus on maintaining support for the CBA and initiating medium-term fiscal adjustment, in order to meet the Maastricht Treaty deficit criteria, could become challenging.

First, despite a demonstrated ability of Estonia's labor market to adjust during periods of duress (as exhibited following the 1998-99 Russian crisis), core challenges persist as there is no guarantee that plans such as freezing the government wage bill for 2009-10 will be matched in the private sector.

Second, one cannot dismiss the foreign exchange risks inherent on Estonia's balance sheet, where despite best efforts and the existence of government liquidity buffers, euro-denominated bank loans to (largely unhedged) households and firms contribute to foreign exchange exposures amounting to, respectively, 36 and 42 percent of GDP. These loans are serviced by parents of a concentrated (95 percent) foreign-owned banking sector which have relied on short-term borrowing to fund long-term domestic lending. Staff contend that "if unaddressed, the liquidity squeeze could disrupt the banking sector and create pressure to abandon the CBA."

Finally, achieving a real exchange rate adjustment via fiscal austerity and severe economic contraction, unaided by nominal exchange rate adjustment, can prove a very difficult and costly process.

On the other hand, one cannot discount the negative consequences "changing course" could have with respect to contagion effects in the region (and during an extremely volatile period globally). We also do recognize the desire of the Estonian authorities to maintain strict adherence to the requirements for euro adoption, and that adjustment accompanied by immediate adoption of the euro is likely not available.

Fiscal Situation

Notwithstanding the remarkable past fiscal performances resulting in surpluses in excess of 3 percent of GDP and moderate public debt, Estonian fiscal policy is guided by the need to maintain a fiscal buffer, so long as global illiquidity make borrowing difficult, and ensure that the deficit does not jeopardize euro adoption by exceeding the 3 percent of GDP Maastricht ceiling. This raises the possibility of a constraint as opposed to an analytical decision that additional stimulus is not needed. Would the Estonian economy benefit from a relatively procyclical stance as it weathers the current crisis? The staff notes "that large expenditure increases in the last two years already place Estonia on an unsustainable path, and leave little room for countercyclical measures which would anyway be of only modest impact." This seems to conclude that any breach of the Maastricht deficit ceiling would have little impact on the Estonian economy during this crisis.

We would benefit from staff's views and supporting arguments on this conclusion. Without holding a strong position either way, at the core is exploring further whether Estonia would be better off with more aggressive fiscal loosening at this time, even if it meant breaching the Maastricht deficit ceiling. The document could stand for additional comment on how this all factors into the staff assessment here.

Financial Sector Developments

On the financial sector, we certainly applaud the authorities' decision to implement the main recommendations of the FSAP-update mission. In addition, its prudent financial sector regulation has allowed its banks to remain profitable in 2008, while maintaining low NPL ratios. Having said this, as noted in the discussion on exchange rates, Estonian's financial sector is highly concentrated, is almost entirely foreign-owned, and is exposed to both unhedged euro-denominated lending and mismatched maturities between the parent Nordic banks and the Estonian subsidiaries. The well-being of the Estonian banking system, therefore, appears to hinge significantly on the banks' home country policies. Can the staff provide greater clarity on the policy options at Estonia's disposal to maintain the health of its financial sector given this context?

> While the Estonians seem to have been proactive in their approach to financial regulation, and should be commended for this, at the root remains uncertainty over both liquidity and credit risk exposure. The FSAP Update recently concluded highlights the need for authorities to more fully develop its financial safety net, including implementing a lender-of-last-resort (LOLR) capability and an expanded bank resolution framework. What is not clear is the priority the FSAP team places on euro adoption, and the extent to which this would address the core risks inherent within the Estonian financial system. This question is also in relation to the Article IV team's assertion that "staff agreed that a key objective should be euro adoption, to reduce vulnerability to financial turbulence."
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> With this, we wish the authorities well.

Extending his earlier remarks, Mr. Henriksson reported that the Estonian Central Bank and the Swedish Riksbank had publicly announced on Friday an agreement to provide emergency liquidity assistance to Swedish banking subsidiaries in Estonia, if needed. This precautionary arrangement enabled the Eesti Pank to borrow up to SEK 10 billion against Estonian kroons, and had been positively received by both SEB and Swedbank.

The staff representative from the European Department (Mr. Rozwadowski), in response to Executive Directors' questions and comments, made the following statement:

> I would like to group my responses to issues raised in the statements under the following headings: the macroeconomic outlook; fiscal policy; the external sector; and structural reforms. I will ask Mr. Seelig to take up the questions on the banking sector since those overlap with the work which was done under the Financial Sector Assessment Program.
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> On the macroeconomic outlook, the questions focused on what would happen in the event that global conditions deteriorate more than expected. Clearly, things would become more difficult in Estonia. This would spill over in the form of slower growth and a deterioration of the performance of banks' assets. The going would get rougher.
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> What risks might this pose for the currency board arrangement? The currency board arrangement is a strong system that

would provide adequate protection against a currency run. However, it could come under significant stress if a currency run were associated with a severe bank run, as it likely would be. This is why the existing liquidity buffers in the form of high reserve requirements are important. It is also why the agreement with the Riksbank is important in providing further buffers. Taken together, the reserve requirements and the emergency liquidity assistance cover approximately 45 percent of domestic deposits, which is fairly significant.

How would the authorities react to a continued deterioration in the outlook? We have not discussed discretionary contingency plans at the macro level, but it is clear that the response would have three main elements: (i) relying on the flexibility of the labor market and the general flexibility of the economy to facilitate adjustment and cushion the blow; (ii) a commitment to do whatever is necessary to support and underpin the currency board arrangement; and (iii) a commitment to do whatever is necessary to assure euro adoption as soon as possible. The latter would involve a sustained fiscal effort.

We were asked to elaborate on the fiscal stance in the 2009 budget; in particular, the further tightening under the supplementary budget. I believe the underlying question here is whether there is room in Estonia for countercyclical fiscal policy to cushion the slowdown? We think not. In an economy that is as small and as open as Estonia is, the impact of a fiscal stimulus would be small, so there is relatively little 'bang for the buck.'

Indeed, there is a compelling case for a continued tight fiscal stance. First, this is necessary to maintain Estonia's fiscal buffers. Estonia has currently some 8.5 percent of GDP worth of liquid assets that it can use to cover deficits over the next two or three years, if necessary, without having to go to the markets. This is a very important asset under current conditions and needs to be protected. This also protects the currency board arrangement.

Second, medium-term fiscal sustainability argues for a tight fiscal stance. Although the fiscal position has been strong over the years, it eroded in cyclically-adjusted terms during the boom. Indeed, it eroded to the point that the cyclically-adjusted position was in deficit, thus Estonia ate up some of the fiscal room that it might otherwise have had. With the revised budget, the cyclical balance is a

small surplus, around 1 percent of GDP, although it is hard to assess under current circumstances. We think that that is about right.

Finally, a tight fiscal stance would help to meet the Maastricht criterion, which has been pointed out as a constraint. I am not sure if it is the binding constraint in this case; the others are also important. But it is true that the authorities view this as very important objective, one which staff supports.

There were questions on fiscal rules and budget flexibility. Have the authorities considered a fiscal rule? Yes. On an informal basis, the authorities have long operated under a rule of always having the budget in balance or better. This has served as the basis of the fiscal buffer that accumulated over the years, although, as indicated, it was perhaps not sufficient to maintain a fiscal position that would have been desirable during the boom times where something better than that was needed. The Estonian authorities have an informal apparatus—a Medium-Term Budgetary Framework—in which they specify budget targets over a four-year horizon. At this stage, it perhaps has more of an indicative role. Looking forward, there is certainly scope for its strengthening.

The budget has a good deal of inflexibility. Some 70 percent of expenditures are determined by entitlements and earmarks, and it is going to be difficult to increase the degree of flexibility in the economy, although the authorities seemed determined to do so. For the longer term, our advice would be to put in place and adhere to a medium-term fiscal rule that would then allow automatic stabilizers to come into play through the cycle and reduce the reliance on discretionary fiscal measures.

Turning to the external sector, there were questions on the benefits of euro adoption. I would identify two key benefits. First, euro adoption would eliminate whatever residual currency risk remains in Estonia and neutralize currency exposures, because the exposures are all predominantly kroon versus euro; if it was all euro, there would be no further exposures. Second, entry into the euro system would give Estonia access to the usual lender-of-last-resort procedures that are available to Euro area central banks. The agreement with the Swedish Riksbank helps here, but it would be good also to have access to the standard euro facilities.

In terms of the timing of euro adoption, Estonia must meet the Maastricht criteria. Currently, it does not meet the inflation criterion and the fiscal criterion is at risk, although with the recent fiscal tightening it looks as though that may well be met, as it has been in the past, and continue to be met. With inflation coming down rapidly, the inflation criterion may also be met fairly soon. The authorities expect that the Maastricht criteria will be met by 2010, which would allow euro adoption by 2011. That seems plausible to us.

There were questions on competitiveness and the real exchange rate. As we reported, our assessment shows some overvaluation of the kroon over quite a wide range. The view of the authorities, which is also the view of the staff, is that the lower end of that range is probably closer to the actual state of affairs. There are a number of reasons for that, some of which are technical and which we could take up bilaterally if there are further questions.

There was a question about Estonia's export performance. The story is a bit complicated. Exports were very strong until about 2005, suggesting that until that point there was a very high degree of competitiveness. Thereafter export growth slowed, partly reflecting the impact of a very sharp increase in real wages, as well as some one-off effects of a reduction in transit trade. What does this tell us? It suggests that the very strong competitive advantage that there was until 2005 is no longer as strong. We have seen a slowing of export growth, but we have not seen a reduction in exports or any significant erosion of export share. This is the basis of the staff's view that, so long as the recent trend of real wages running ahead of productivity is halted, competitiveness should continue to be adequate.

In assessing external stability, did we take into account the likelihood that there may be further real depreciations in the pipeline? No, we did not. The assessment is based on the existing real exchange rate. That said, a further real depreciation in Estonia could be helpful. One should not forget that many countries are experiencing real depreciations, and some neighboring countries are seeing nominal depreciations or reductions in the real wage. It is not clear how much of an impact this will have on Estonia relative to all of its trading partners.

What are the implications of the overvaluation? A sustained overvaluation would delay the recovery and could lead to sluggish

growth over several years, which would lead to an erosion of banks' assets and further stress on the financial sector.

Finally, a couple of remarks on structural reforms. Does Estonia have sufficient capacity to reallocate resources to the tradable sector? What steps are being taken to ensure this, in addition to the labor market reforms that we discussed? I think one needs to recall that the Estonian economy is already one of the most flexible among emerging Europe, possibly in Europe. The Estonian labor market is more akin a U.S. labor market than a European labor market, e.g. in terms of indices of job turnover. There is not a lot of inflexibility in the economy. The authorities are taking steps to further improve the business climate, but we are in the realm of second-order reforms and diminishing returns at this stage.

On social safety nets and the new labor law, staff very much welcomes the package that the authorities have put in place to increase flexibility and strengthen social safety nets. In our view, the social safety nets are important in themselves, not just as the political price that might need to be paid in order to get the additional flexibility. The only concern, as flagged in the staff report, is to ensure that they are properly costed, budgeted, and designed to minimize distortions.

The staff representative from the Monetary and Capital Markets Department (Mr. Seelig), in response to Executive Directors' questions and comments, made the following statement:

On the banking sector, there were several questions on the impact of a further deterioration in the economy and whether this has been captured by the stress tests.

With regard to a deterioration of economic conditions, the feed-through mechanism is nonperforming loans, which will continue to rise. Banks will need to provision more and they may need some additional capital in order to meet the prudential requirements. We started conducting stress tests last February when the economic environment was considerably more benign. These were updated in December to reflect the economy at that point in time. In terms of the results, the updated stress tests present two scenarios. One applies a loss-given default of 42 percent, i.e. how much is lost if a loan stops paying, which is what the authorities have indicated is the historic experience going back to the last downturn; and another scenario

assumes losses of 100 percent. Focusing on the 100 percent loss, which is probably unrealistic given that these are real estate loans, provides an added measure of conservatism. The results highlight the resilience of the banking sector. The large Estonian banks have been extremely profitable over the last few years, and thus have managed to build up their capital buffers. As compared to most of the world, 2008 was still a very good year for Estonian banks; perhaps not as good as the year before, but still a profitable year. Hopefully, this buffer can see them through the crisis.

Another set of questions dealt with the cooperative arrangements among countries in the region, in particular the arrangement with Riksbank. I would be glad to bilaterally give anyone who wants more details on that arrangement and its mechanics. It is useful to develop these types of bilateral relationships, especially for smaller countries with a banking sector that is dominated by a few banks that come from one or two countries.

The arrangement is consistent with Estonia's currency board arrangement. There was a question about whether having this emergency liquidity assistance facility would compromise the currency board arrangement. It does not. Simply put, effectively the Riksbank would be providing the liquidity, and the Estonian authorities are underwriting the credit risk in making the loans.

There was a paragraph in the staff report about the good working relationship between Estonia and its neighbors, notwithstanding the fact that it also has all these formal agreements. An Executive Directors asked what lessons might be derived from that experience. I think the lesson that one can take from that is you can develop memoranda of understanding and formal agreements ad nauseam, but you cannot anticipate events or shocks. Having good working relationships, where people feel comfortable picking up the phone and calling each other and sharing information, allow countries to deal with a crisis or with an issue that they have not anticipated before in a way that probably is more powerful than what a formal, legally-binding agreement can do. I think in the case of Estonia, we saw evidence of that with the liquidity crisis that was experienced this past fall.

There was also a question on cross-border preparations among the countries. Estonia has done a great deal domestically in terms of

having committees and memoranda of understanding internally to prepare for a crisis. They have also taken part in the Nordic-Baltic exercise that was hosted by the Riksbank a year ago. That said, the FSAP team felt there was a need to do a bit more. There was a recommendation that they undertake a regional crisis exercise that assumed that one of the two big banks gets into trouble. This exercise would include Sweden plus the other Baltic countries to make sure they have all the information flows and would know how to handle that type of a situation.

There was a question about burden sharing. There are no explicit burden sharing agreements in place, though the Estonian authorities have indicated that they have some interest in entering into those types of agreements. They are hoping that the law that they have submitted to parliament to allow them to access budget funds in the event of a crisis will facilitate that objective.

There were questions on prudential supervisory issues. One dealt with the risk weight that is applied to real estate loans in Estonia. The risk weight has been set at 60 percent; while this is a decline from 100 percent, it does exceed the 35 percent international standard adopted by the Basel Committee and the European Union Committee of Bank Supervisors.

In terms of the two large banks, my understanding is that the large parent banks have adopted the internal ratings-based (IRB) approaches as specified under Basel II. The Swedish supervisors are monitoring to make sure that the models adequately reflect the risks of this type of lending.

There was also a question about prudential options to limit the explosive growth in unhedged borrowing. In the case of Estonia, in part because of the EU membership and the aspirations of joining the Euro area, as well as their faith in the currency board, the authorities do not see the need to have any prudential measures as it relates to euro borrowing. Other countries have dealt with this issue by imposing additional capital charges or higher risk weights on unhedged loans. As more countries shift to Basel II, supervisors should account for that risk in their evaluation of the IRB models.

The Estonian banking system is, to some extent, constrained by home country policies. What options do they have as a host country?

First, an area where the Estonians have done an excellent job concerns maintaining a strong supervisory capacity in order to supervise the subsidiary banks properly and in a cooperative way with the home country. They also have the ability to put in place a safety net, and in this case the Estonian authorities have deposit insurance. They have now put in place the ELA capacity. One area that there is still a need to do further work is on the bank resolution framework.

There was a question on why the FSAP team did not put a bigger priority on euro adoption. That is a difficult question. When we formulate recommendations for an FSAP, we tend to try to formulate recommendations which the authorities can unilaterally implement or, in some cases, bilaterally implement if it involves a neighboring country. Euro adoption is not completely under the control or within the discretion of the Estonian authorities. While we agreed that adopting the euro would go a long way to resolving a number of vulnerabilities in the financial sector, we thought that was not a useful role for us in the FSAP process and rather tried to deal with measures that could be used in its place.

Lastly, there was a question about why economic entities strongly prefer euro-denominated loans. The parent banks initially borrow from European interbank markets and try to hedge that exposure by on-lending to the banks in Estonia in euros. Those banks try to hedge that exposure as well by also lending in euros. As far as the customers go, because of the breadth of that market versus the kroon market, typically the interest rates are going to be lower on euro loans. Again, I think borrowing in euros is also tied to the goal of the country, which is to become part of the Euro area.

The representative from the European Central Bank (Mr. Pineau) made the following statement:

Estonia is adjusting to a rapid unwinding of imbalances built up over the last years. The authorities have been able to avoid a disorderly hard landing, and the statement by Mr. Henriksson and Ms. Leemets confirms that the authorities are determined to address remaining vulnerabilities while preserving the medium-term growth capacity of the economy. I will just say a few words on the short-term outlook, fiscal policy, the exchange rate and competitiveness, and the financial system.

On the near-term outlook, as mentioned by the staff, we all know that there are uncertainties. The latest projection by the central bank of Estonia shows that, indeed, after contracting by more than 4 percent this year, the economy might contract by more than 6 percent this year. The adjustment is quite significant, and this has implications for fiscal policy in particular.

On fiscal policy, it is regrettable that, as mentioned in the staff paper, since 2007 there has been some slippage in fiscal policy which, up until 2007, had been rather conservative in line with the requirements of the currency board. We agree with IMF staff that there is a need for the authorities to make sure that the sustainability of public finances is maintained. The recent measures taken by the authorities go in the right direction.

On external competitiveness, yes, we broadly agree also with the staff: if there is some overvaluation, the size is certainly rather small. In terms of direction, the latest developments seem to confirm that the risks there are rather small and that there is no indication that the recent appreciation will continue at least at a pace that might be problematic. We consider that these risks to competitiveness are manageable within the currency board arrangement.

With respect to euro adoption and whether the euro is a safe haven or a safer haven than a currency board, I think we tend to agree with the authorities that certainly the euro is providing an adequate anchor to orient domestic policies as they have been doing in the past. From this perspective, the authorities have the right approach to this convergence process.

With respect to the financial system and financial stability, we consider that there are risks ahead given the very sharp contraction which will increase the need for provisioning by banks, but the existing buffers are fairly large.

On the swap arrangement between Riksbank and the Central Bank of Estonia, it is certainly a welcome move. This is fully consistent with arrangements at the EU level and, in particular, in line with the Memorandum of Understanding adopted last year when it comes to cross-border financial stability and the need for close cooperation among EU countries.

Mr. Yamaoka asked the staff to elaborate on potential policy options to mitigate downside shocks to the real sector, particularly in light of the constraints imposed by the currency board arrangement.

Mr. Hills wondered if the staff could discuss the interaction between the financial sector and the real economy. It had argued that the Estonian banks were in a reasonably good financial position given their buffers, but might there be potential risks to credit provision to the real economy?

Mr. Daïri expressed some surprise by the staff's indication that a further depreciation of the real exchange rate might not be very helpful because of the currency depreciations occurring elsewhere. Might that imply that the ensuing appreciation in relative terms would not be important, or might this be a means for the staff to emphasize the importance of structural reforms to improve competitiveness?

Ms. Xafa asked for further operational details on the arrangement with the Swedish Riksbank. It appeared that the latter would stand ready to provide liquidity, while the Estonian authorities assumed the credit risk of the local subsidiaries of foreign banks. In the event that the economic deterioration led to a significant rise in nonperforming loans, she wondered who would be responsible for increasing the capital of the banks.

The staff representative from the European Department (Mr. Rozwadowski), in further response to Executive Directors' questions and comments, made the following additional statement:

> I will take the questions in the order that they came. On shocks to the real economy and how the adjustment can take place, it is true that with a currency board, a fixed exchange rate regime, or a currency union, one sets aside a potential instrument for bringing about the adjustment; namely, the exchange rate. In doing so, you need to assess how much you are really giving up. The answer to that depends on the specific circumstances of the country. Generally, in a very small, very open economy, the extent to which you can change relative prices by changing the exchange rate is very limited, because you can expect very high rates of pass-through from the exchange rate to prices and wages. In the case of Estonia, that is perhaps even more so than in other countries; not only are goods mobile across frontiers, but so is labor, and the pass-through to the wage could be expected to be quite quick and full.

What alternatives do you have? Again, in the case of Estonia, the alternatives to an adjustment through the exchange rate are an adjustment directly through wages and prices which, in our view, is an effective mechanism in this country because of the flexibility of the labor market.

In Estonia, a very large part of salaries, ranging from something like 7 to sometimes as much as 20 percent, is in the form of bonuses, which can be eliminated without any difficulty at all, which indeed has been the case in the last few months. As such, there is a capacity for rapid adjustment.

On the interaction between the real sector and the financial sectors, our discussions of the slowdown in Estonia have come frequently back to the question of what is driving what. Is it the slowdown in credit that is driving the slowdown in demand, or is it the slowdown in demand that is driving the slowdown in credit? Frankly, it is not always easy to unwrap that package. The answer, presumably, is both. It may depend at which phase of the slowdown you are looking at. Initially, there was a slowdown of credit that perhaps was driving demand. However, in the last 12 months confidence indicators have collapsed, and so perhaps demand has taken precedence over credit.

On the statement that a further depreciation would not help that much, I would not want to go too far with that assertion. I would not assert that Estonia can get by without a further depreciation because, if other countries are depreciating in the neighborhood, you need to depreciate just to keep up. I would not want my remarks to be carried too far. But I do not think one can count too much on that being the solution to the problem.

On the ELA agreement, yes, you have characterized it correctly. The basic structure is that of a swap or a cross deposit, where the two central banks each make a deposit in the other. This gives the Riksbank the Estonian kroons that it can use to provide liquidity to the subsidiaries of Swedish banks in Estonia. Those liquidity loans are collateralized, and the collateral is underwritten by the Estonian Central Bank and, ultimately, by the Estonian budget.

Finally, who in the final analysis is responsible for the banks? This is a very important question when you are looking at banking

sectors that have the cross-country features of the Nordic banking systems. The answer depends on whether you are talking about branches or subsidiaries. In the case of Estonia, the major banks are subsidiaries. The Estonians are putting in place a mechanism to ease procedures to inject budget capital into the banks, but only if the parent banks are unable to do so.

Ms. Lundsager made the following statement:

Despite your answer to Mr. Daïri's question about depreciation and the need to keep up with what is going on in neighboring countries, I still get the sense that you think Estonia is fairly ready to move toward the euro. You emphasized the flexibility of the economy in terms of wages and prices. So—and I put this out to colleagues maybe more than to staff—in these extraordinary times, is there not maybe an opportunity for the European Central Bank to consider accelerating euro adoption in the countries that are making good progress. I realize that inflation is still a problem, and they need to contain the fiscal stance. However, given the need to safeguard stability in such countries, and Estonia is perhaps in a little better place than some of the others to move more quickly; perhaps a signal like that could help in the confidence factor both with Estonia and with some of the other countries. This would be just a suggestion, Mr. Chairman, for our discussions with European leaders.

Mr. Daïri shared Ms. Lundsager's concern, and thanked the staff for its clarification. He wondered if the Estonian authorities assumed the exchange rate risks under the arrangement with Sweden.

The staff representative from the European Department (Mr. Rozwadowski) confirmed that the Estonian Central Bank carried the exchange rate risk.

Mr. Henriksson made the following concluding statement:

Let me begin by extending my authorities' appreciation to the long and excellent working relations with the Mission Chief and his team members. My Estonian authorities would also like to thank the Board for their thorough but supportive statements. Their views will be faithfully transmitted to my Estonian authorities. As I wrote a long preliminary statement, I can limit myself to some brief remarks about euro adoption and have one minor comment.

Euro adoption is the key strategic goal for Estonia. Estonia has never taken euro adoption as granted or as an option that would make adjustment in the economy less necessary. It is rather the opposite, as the challenges the authorities have faced in fulfilling the Maastricht inflation criterion make very clear. This is a country where income convergence has occurred at a particularly fast pace. It has reformed its tax system and front-loaded increases in indirect tax rates to the EU minimum levels, and has done all this while functioning under a fixed exchange rate. The fact that all other criteria have been fulfilled since 2006 is testament to the authorities' strong commitment toward their goal. The authorities believe that the economy is flexible and fully capable of functioning within the constraints of the European Monetary Union. The currency board arrangement remains the overarching pillar for monetary and financial stability by providing the credible anchor for price expectations over the medium- and long-term. Thus, Estonia has already been mimicking life under the Euro area framework for 17 years, reflecting the flexibility of its markets. The authorities strongly believe that an orderly entrance to the EMU is the only credible exit strategy from the current monetary arrangement.

Finally, I have already touched upon the strengthening of the Financial Safety Net through the introduction of an agreement on Emergency Liquidity Assistance. However, it is important to note that, despite the significant decrease in credit demand and some tightening of credit conditions, there has been nothing in the banking sector that could be characterized as a liquidity shortfall.

The Acting Chair (Mr. Kato) made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They 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 nontraded 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.

It is expected that the next Article IV consultation with the Republic of Estonia will be held on the standard 12-month cycle.

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G. RUSSELL KINCAID
Acting Secretary