BUFF/09/208

December 29, 2009

Statement by the Staff Representative on Republic of Estonia
Executive Board Meeting
January 6, 2010

1. **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.

2. **Recent macroeconomic developments are largely in line with expectations.** Third quarter GDP declined by 3 percent (Q3/Q2, adjusted for seasonal and working day factors) and by 15.6 percent compared to the same quarter of the previous year, with domestic demand continuing to make a strong negative contribution to growth. While this is slightly worse than projected in the staff report, staff's annual growth forecast for 2009 remains unchanged at -15 percent. The current account surplus was equivalent to 6.6 percent of third quarter GDP. Labor's share of value added fell slightly in the third quarter, the second quarterly decrease, while nominal hourly labor costs dropped by 4.3 percent during this period.

3. **As anticipated, inflation fell in November below the Maastricht reference value.** Consumer prices declined both on a monthly and yearly basis. Barring unforeseen developments, the 12 months average inflation rate is expected to remain below the reference value during the coming year.

4. **Financial market spreads have dropped sharply in recent weeks, reflecting both a calming of general market conditions and anticipation of euro adoption.** Three- and six-months forward exchange rate spreads have narrowed to less than 1 percent, interbank interest rate differentials of similar maturities to less than 2 percent, and CDS spreads on 5-year maturities to below 200 basis points.

5. **Higher than expected revenues in recent months have increased the chances of containing the deficit below 3 percent of GDP in both 2009 and 2010, but risks remain.** Improved tax collection, especially for the state budget, have more than offset higher than expected local government deficits, with the overall balance now estimated at ¼ percent of GDP better than previously projected. This better performance may carry forward into 2010. The budget passed on December 9 was in line with staff's expectations, including additional excises on energy introduced after the mission. In addition, the Tallinn municipal government announced its intention to levy a small sales tax from mid-2010. Despite these developments, the assessment in the staff paper remains valid: additional structural measures

should be adopted to provide an adequate safety margin for meeting the deficit target 2010 and to support achieving the targeted medium-term structural balance.

6. The authorities have made further progress in implementing the recommendations of the FSAP update. The Bank of Estonia's Monetary Policy Committee approved its contingency plans for liquidity purposes. In addition, a bill on a bank resolution framework has been prepared, and will soon be presented to Parliament.