DOCUMENT OF INTERNATIONAL MONETARY FUND AND FOR OFFICIAL USE ONLY

The contents of this document are preliminary and subject to change.

GRAY/09/730
Revised: 2/27/09

February 26, 2009

Statement by Mr. Stein and Mr. von Stenglin on Republic of Estonia
(Preliminary)
Executive Board Meeting 09/21
March 2, 2009

We thank staff for an interesting and concise set of papers, and Mr. Henriksson and Ms. Leemets for their insightful buff 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' signalling 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 autorities 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 Programme submitted by the Estonian authorities in early December, more recently-announced measures aim at keeping the general government deficit below 3 % 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-tradeable to the tradeable 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.