GRAY/09/749
Revised

February 27, 2009

**Statement by Mr. Warjiyo and Mr. Waqabaca on Republic of Estonia**
**(Preliminary)**
**Executive Board Meeting 09/21**
**March 2, 2009**

1. 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.

2. 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.

3. 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**

4. 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?*

5. 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 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**

6. 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 and Ms. Leemet'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**

7. The Estonian financial sector continues to benefit from parent support in the face of

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.

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.

8. 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.

9. 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.*

**Labour Market Reforms and the Social Safety Net**

10. We take note of staff's assessment that the overall flexibility of the Estonian labour 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.*

11. 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.