**IMMEDIATE ATTENTION**

SM/11/297
Supplement 2

November 16, 2011

To: Members of the Executive Board

From: The Secretary

Subject: **Republic of Estonia—Staff Report for the 2011 Article IV Consultation—Draft Public Information Notice**

Attached for consideration by the Executive Directors is the draft Public Information Notice (PIN) relating to the staff report for the 2011 Article IV consultation with the Republic of Estonia (SM/11/297, 11/10/11), which is being considered on a lapse of time basis. In the absence of a request for a Board discussion by **noon on Tuesday, November 22, 2011**, the Executive Board Assessment section of the PIN will be based on the staff appraisal, as attached.

Unless an objection from the authorities of the Republic of Estonia is received prior to the conclusion of the Board's consideration, the PIN will be published. Any requests for modifications for publication are expected to be received two days before the Board concludes its consideration.

Questions may be referred to Mr. Hoffmaister (ext. 35883) and Mr. Lutz (ext. 36588) in EUR.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the European Central Bank and the WTO Secretariat forthwith; and to the European Bank for Reconstruction and Development, the European Commission, the European Investment Bank, and the Organisation for Economic Cooperation and Development, following its consideration by the Executive Board.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (1)

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EXTERNAL RELATIONS DEPARTMENT

Draft Public Information Notice (PIN)

Public Information Notice (PIN) No. 11/xx
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# IMF Executive Board Concludes Article IV Consultation with the Republic of Estonia

On December 2, 2011, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Estonia, and considered and endorsed the staff appraisal without a meeting.[1]

## Background

A vibrant recovery has marked Estonia's first year in the euro area, albeit amid nascent tensions. The economy's strong rebound has been grounded in a proven track record of prudent macroeconomic policies, which also underpinned a successful euro adoption and a recent credit rating upgrade. But coming on the heels of one of the EU's deepest economic contractions, the recovery has exposed underlying difficulties. Price pressures have emerged (still mainly imported) and unemployment, while declining, remains high with long-term joblessness on the rise. The latter has mostly reflected mismatched skills.

Following strong growth in 2011—among the highest in the EU—the pace of economic activity and price increases are set to moderate in 2012. In line with weakening export markets, growth is projected to slow to about 3 percent. This is expected to be only partially offset by stronger final domestic demand. The output gap will nonetheless continue to narrow in 2012. Inflation should also moderate as the impact of global food

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

and fuel prices shocks dissipate. Core inflation's outlook remains uncertain given wage pressures largely stemming from labor shortages and mismatched skills. So far, wages increases have not exceeded productivity gains nor have real wages risen. As a result, economy-wide profitability and external competitiveness have improved. These trends are likely to broadly continue but pressures can remain on core inflation.

With continued volatility in global financial markets, downside risks to the outlook have risen at end-2011. With two-thirds of Estonia's exports going to the EU, recent European and global developments have tilted risks to the downside. Besides the domestic risk that the unwinding past real and financial sector imbalances be more protracted and weigh on domestic demand, external risks associated with the euro area sovereign debt crisis prevail.

**Executive Board Assessment**

In concluding the 2011 Article IV consultation with Estonia, Executive Directors endorsed the staff's appraisal as follows:

Estonia faces an increasingly challenging environment as it looks to continue implementing policies preserving macroeconomic policy credibility and safeguarding sustainable growth. Following a strong recovery in its first year in the euro area, Estonia's economic activity will likely slow in 2012. In the central scenario, nonetheless, Estonia's economy will continue to approach its potential. Inflation is poised to slow even though pressures on core inflation can remain. Recently, downside risks to the outlook have increased. In addition to a slowdown in exports, a generalized confidence fallout from the euro area sovereign debt crisis could spill over to Estonia despite its strong fundamentals.

Estonia's fiscal position will remain strong but there will be a need to limit the stimulative impact of the 2012 budget in the central scenario, albeit uncertainties abound. Time-bound increases in public investment underlie the budget's positive impulse, while a neutral budget would be appropriate. Recognizing that further significant compression of current expenditures is unrealistic, observance of budgetary allocations will be helpful in this regard. But if downside risks materialize, automatic stabilizers should be allowed to operate while maintaining Estonia's hard-earned fiscal credibility. In addition, given the uncertainty regarding the extent and duration of the global slowdown, fiscal buffers should be preserved and alternative sources of financing be considered.

Looking beyond the current conjuncture, the authorities' medium-term target can safeguard Estonia's strong fiscal position. This will require continued expenditure restraint to counter spending pressures that are likely to emerge. The authorities' ongoing efforts to enhance central government productivity through centralization of accounting and personnel management can help. Still without raising taxes, achieving the fiscal target on a sustainable basis, implementing the authorities' plan to reduce labor taxation, and restore fiscal buffers will require reducing non-wage goods and services by at least 2 percentage points of GDP in the medium term. The pace of consolidation should be mindful of long-term investment needs and cyclical developments.

A fully fledged multi-year fiscal framework can support the medium-term target, bolster Estonia's high fiscal credibility, and limit pro-cyclical policies. A successful framework should reflect Estonia's fiscal tradition of simplicity and transparency, which has facilitated monitoring and accountability. The central element of such a framework would be multi-year expenditure ceilings and their strict observance while revenue collections adjust to cyclical conditions. In addition, fiscal buffers should continue to be an integral part of Estonia's fiscal framework. While there are benefits as well as costs of holding liquid assets, gradually rebuilding buffers appears appropriate given increased global uncertainty.

For the financial sector, the challenge entails safeguarding stability in the context of heightened global financial tension. Estonian banks have scant direct and indirect exposure to euro area sovereign debt, while at the same time capital and liquidity buffers have increased substantially since 2007. However, the legacy of the previous crisis continues to burden balance sheets and dependence on financing from parent banks remains high, although both of these factors are declining. The latter has proven a stable source of financing, but parent banks in turn rely on short-term wholesale funding. Limiting potential contagion will thus require continued improvements in cross-border supervision. Developing regional crisis resolution tools—in close cooperation with relevant authorities—can provide critical backstop to Estonia's sizable fiscal and financial buffers. The scheduled December high-level meeting of Nordic regulators provides an opportunity to make progress in this critical area. In addition, an early and gradual institutional adoption of Basel III requirements can reduce funding risks but its implementation should avoiding creating headwinds for credit conditions.

Financial resilience can also be supported by further enhancing the regional and domestic resolution frameworks for banks and addressing weaknesses in Estonia's bankruptcy law. The recent adoption of a domestic resolution law provides a welcome tool to minimize the cost of a bank failure. This could be supplemented by introducing a bank-asset separation authority as well as by developing cross-border bank resolution tools in coordination with the EU and regional partners. In addition, legal clarifications regarding the Reorganization Act for corporations have improved its effectiveness, while the recent adoption of an analogous law for individuals ensures broader coverage. Still, reforms are needed to shorten the lengthy and costly bankruptcy process.

More broadly, sustainable growth will entail enhancing Estonia's attractiveness for FDI, addressing skill mismatches, and increasing human capital. Estonia's 2020 Competitiveness Strategy highlights the need for further improvements in the business environment to continue to draw FDI. The urgency of boosting knowledge-based activities and remaining an attractive destination for FDI has been heightened by growing competition from emerging markets. Furthermore, fully drawing on Estonia's resources and developing their potential will also require addressing skill mismatches and continuing attention to foster human resources in technical fields as well as to attract highly-trained individuals to support sustainable income convergence to EU levels.

***Public Information Notices (PINs)*** form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Estonia: Selected Macroeconomic and Social Indicators, 2009–12
(In units as indicated)

| | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|
| | | | Projection | |
| **National income, prices and wages** | | | | |
| GDP (euro, billions) | 13.8 | 14.3 | 15.8 | 16.7 |
| Real GDP growth (year-on-year in percent) | -14.3 | 2.3 | 7.5 | 3.1 |
| Average HICP (year-on-year change in percent) | 0.2 | 2.7 | 5.1 | 3.1 |
| GDP deflator (year-on-year change in percent) | -1.0 | 1.1 | 3.0 | 2.4 |
| Average monthly wage (year-on-year growth in percent) | -4.6 | 0.9 | 4.5 | 4.7 |
| Unemployment rate (ILO definition, percent) | 13.8 | 16.9 | 13.5 | 11.5 |
| Average nominal ULC (year-on-year growth in percent) | 0.9 | -5.4 | 0.6 | 3.1 |
| **Saving-investment balances (in percent of GDP)** | | | | |
| National saving | 22.5 | 23.1 | 24.9 | 25.0 |
| Private | 24.6 | 23.4 | 25.6 | 28.1 |
| Public | -2.1 | -0.3 | -0.7 | -3.1 |
| Domestic investment | 18.8 | 19.5 | 22.4 | 22.9 |
| Private | 15.4 | 16.6 | 19.7 | 19.7 |
| Public | 3.4 | 3.0 | 2.7 | 3.1 |
| Foreign saving | -3.7 | -3.6 | -2.6 | -2.1 |
| **General government (ESA95 basis; percent of GDP)** | | | | |
| Revenue and grants | 43.2 | 40.9 | 41.0 | 39.5 |
| Expenditure and net lending | 45.2 | 40.6 | 40.7 | 41.8 |
| Fiscal balance | -2.0 | 0.3 | 0.3 | -2.3 |
| **External sector (in percent of GDP)** | | | | |
| Trade balance | -4.0 | -1.7 | 0.2 | -0.6 |
| Service balance | 9.8 | 9.2 | 6.8 | 6.5 |
| Income balance | -3.6 | -5.6 | -5.7 | -5.3 |
| Current account | 3.7 | 3.6 | 2.6 | 2.1 |
| Gross international reserves (euro, millions) | 2766 | 1935 | … | … |
| In months of imports | 4.7 | 2.6 | … | … |
| In percent of gross short-term debt (including trade credits) | 41.6 | 32.7 | … | … |
| In percent of base money | 121.8 | 82.9 | … | … |
| Gross external debt/GDP (in percent) 1/ | 125.0 | 120.0 | 93.5 | 88.7 |
| Net external debt/GDP (in percent) 2/ | 35.2 | 28.7 | 13.1 | 2.8 |
| General government external debt/GDP (in percent) | | | | |
| Excluding government assets held abroad | 5.4 | 4.9 | 4.5 | 4.2 |
| Including government assets held abroad 3/ | -3.0 | -2.1 | -1.9 | -1.8 |
| **Exchange rate (EEK/US$ - period average)** 4/ | 11.3 | 11.8 | … | … |
| **Money and credit (year-on-year growth in percent)** | | | | |
| Domestic credit to nongovernment | -5.3 | -5.0 | … | … |
| Base money | -51 | 39.5 | … | … |
| Broad money | 0.1 | 3.0 | … | … |

Sources: Estonian authorities; and IMF staff estimates and projections
1/ Includes trade credits.
2/ Net of portfolio assets (including money market instruments), financial derivative assets, other investment assets, and reserve assets held by Estonian residents.
3/ Includes the Stabilization Reserve Fund (SRF).
4/ Until 2011, the Estonian kroon was pegged at 15.6466 kroons to the euro. The euro was adopted on January 1, 2011.