© 2005 International Monetary Fund

November 2005
IMF Country Report No. 05/394

Republic of Estonia: 2005 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Republic of Estonia

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2005 Article IV consultation with the Republic of Estonia, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on July 22, 2005, with the officials of the Republic of Estonia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on October 11, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its October 26, 2005 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for the Republic of Estonia.

The document listed below has been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org • Internet: http://www.imf.org

Price: $15.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

REPUBLIC OF ESTONIA

Staff Report for the 2005 Article IV Consultation

Prepared by Staff Representatives for the 2005 Consultation with the Republic of Estonia

Approved by Alessandro Leipold and G. Russell Kincaid

October 11, 2005

The 2005 Article IV consultation discussions were held in Tallinn during July 11–22, 2005. The team comprised Mr. Haas (head), and Messrs. Lutz and Stavrev (all EUR). Messrs. Farelius and Ross, Alternate ED and Senior Advisor, respectively, for the Nordic-Baltic constituency, and Mr. Rosenberg (Regional Representative) attended several meetings. The mission met with the Prime Minister, the Minister of Finance, the Governor of the Bank of Estonia, and other officials, business representatives, academics, and representatives from the trade unions.

Estonia joined the European Union (EU) on May 1, 2004 and entered ERM II on June 27, 2004. A three-party center-left coalition government took office in April 2005; the next general election is scheduled for 2007.

Estonia has accepted the obligations of Article VIII, section 2, 3, and 4, and maintains no restrictions on the making of payments and transfers for current international transactions, except for those imposed in compliance with applicable UN Security Council resolutions. All such restrictions have been notified to the Fund pursuant to Decision No. 144 (52/51).

Estonia has subscribed to the Special Data Dissemination Standard. Coverage, periodicity, and timeliness of the data are adequate for surveillance.

The authorities released the mission's concluding statement (http://www.imf.org/external/np/ms/2005/072205.htm) and have expressed their intention to publish the staff report.

Contents Page

Executive Summary....3

I. Background....4

II. Report on the Discussions....9
A. Economic Outlook and Risks....9
B. Fiscal Policy....11
C. Financial Policy and Euro Adoption Issues....12
D. Structural and Other Issues....14

III. Staff Appraisal....15

Tables
1. Selected Macroeconomic Indicators, 2000-06....23
2. Summary Balance of Payments 2000-10....24
3. Macroeconomic Framework, 2000-10....25
4. Summary of General Government Operations, 2000-06....26
5. Selected Financial Indicators, 2000-05....27
6. Indicators of External Vulnerability, 2000-05....28
7. External Debt Sustainability Framework, 2000-10....29
8. Vulnerability Indicators for Emerging Market Economies, 2004....30
9. Macroeconomic Framework—Baseline and Alternative Scenarios....31

Figures
1. New EU8 Member States: Progress in Income Convergence to EU 15....18
2. Current Account, FDI, and External Debt....19
3. New EU8 Countries: Real Effective Exchange Rates and Export Penetration, 1995-2005....20
4. Credit Developments in Estonia and Other EU Countries....22

Boxes
1. Article IV Fund Policy Advice Implementation....5

Appendices
I. Fund Relations....32
II. Statistical Issues....35

EXECUTIVE SUMMARY

Background: Growth remains strong in Estonia, reaching 8½ percent in the first half of 2005. After touching 5 percent in March 2005, headline inflation decreased to 4.2 percent in August, but still remains well above the Maastricht criterion. Core inflation is more reassuring and is stable at about 2 percent. The current account deficit widened further in 2004 to 12.7 percent of GDP, but strong export performance is inducing some narrowing in 2005. Fiscal policy eased in 2004 and again in 2005, but the budget is still in surplus, albeit a small one. Credit is growing at a rapid rate; there are signs that the economy is beginning to overheat. Estonia entered ERM2 in June 2004 and unilaterally maintains a currency board arrangement against the euro, which it intends to adopt in 2007.

Outlook: Robust growth is expected to continue, but is forecast to taper off toward potential—some 6-7 percent per year—as from 2006. Headline inflation should fall to 2½ percent in 2006 after a number of one-off factors, including some related to EU accession, pass through the system. Nevertheless, it is unlikely that Estonia will meet the Maastricht inflation criterion by June 2006, the first possible test date. It is more likely that the criterion will be met in late 2006 or early 2007. The current account deficit is expected to decline to more sustainable levels in the medium term as private saving rebounds. The main near-term risk is inflation, which could turn out to be higher than envisioned while persistent high external imbalances and growing debt pose risks over the medium term.

Policy issues and discussions

Fiscal policy was inappropriately expansionary in 2004-05. Estonia has had a history of over-performance in achieving its balanced budget target. However since 2003, the surpluses have been ever diminishing with the consequence that the public sector has added to demand pressures at a time when the economy was nearing potential and external imbalances were large. Fiscal policy is critical in a currency board country as it is essentially the only effective stabilization tool. Thus the argument for letting the automatic stabilizers work and targeting a balanced budget only over the cycle—not annually—was made. While the authorities acknowledged the need for prudence, they felt that this was met by their commitment to a general government balance or surplus over the medium term, consistent with the provisions of the Stability and Growth Pact.

The authorities shared staff's concerns about high credit growth. While much of the credit boom is an expected component of real convergence, part of it is caused by credit conditions in the euro-zone being looser than warranted for Estonia. Given the constraints of a currency board, the room to maneuver is limited. Nevertheless, the authorities are ready to tighten prudential regulations and further reduce mortgage deductibility if banks relax their credit standards.

Solid export performance and relatively stable real effective exchange rates suggest that the Estonian economy is competitive and the current exchange rate is appropriate. Maintaining flexibility in labor and product markets will be crucial in preserving this competitiveness.

I. Background

1. **Estonia has made extraordinary progress in the 14 years following independence.** It has successfully established a market economy and joined the EU. This was done by following sound macroeconomic policies (broadly consistent with Fund advice (Box 1)) and implementing far-reaching structural reforms which touched virtually every sector of the economy. As a result, the country is witnessing a remarkable convergence in real terms to EU levels, with purchasing power parity per capita income increasing to 46 percent of the EU15 level in 2004 from 32 percent in 1995 (Figure1). Estonia has also achieved significant nominal convergence, meeting all of the Maastricht criteria, save for inflation. The country entered ERM II in late June 2004, unilaterally maintaining its peg to the euro with a currency board arrangement and is aiming at an early euro adoption.

Estonia: Nominal Convergence
(Data for 2004)

	Deficit	Debt	Inflation	Interest rate 1/
	(In percent of GDP)		(In percent)	
Estonia	**1.7**	**4.9**	**3.0**	**4.4**
New EU8 member countries 2/	-3.4	34.9	4.5	5.6
Czech Republic	-3.5	24.1	2.8	4.8
Hungary	-5.4	60.8	6.8	8.2
Latvia	-1.1	15.0	6.2	4.9
Lithuania	-2.2	23.3	1.2	4.5
Poland	-6.5	49.5	3.5	6.9
Slovak Republic	-3.3	43.6	7.5	5.0
Slovenia	-1.9	27.8	3.6	4.7
Memorandum Items:				
Maastricht Convergence criteria, 2004	-3.0	60.0	2.3	6.4
EU25	-2.8	71.2	2.2	4.3

Sources: Eurostat, IFS, and country authorities.

1/ Estonia: interest rates on new kroon-denominated loans to non-financial corporations and households with maturities over five years.
Lithuania: primary market yields of government bonds with maturities of close to ten years.
The rest of the new EU8 countries: secondary market yields of government bonds with maturities close to ten years.
2/ Unweighted average excluding Estonia.

2. **Nonetheless, there are risks in both the short and medium terms:** in the short term, there is the very real risk that inflation will exceed the Maastricht criterion and jeopardize the early adoption of the euro. With average inflation forecast at 4 percent in 2005—well above the estimated Maastricht criterion of about 2¾ percent—meeting the Maastricht inflation criterion in June 2006 (the earliest possible test date) is increasingly unlikely. Over the medium term, vulnerability to external shocks remains, with a persistent and large current account deficit and a rapidly expanding stock of gross external debt. The current account deficit averaged slightly above 8 percent of GDP during 1995–2004 with FDI financing three quarters of the gap. However, over the last three years, FDI coverage of the current account has dropped to about half of the deficit and bank credit has increased. This has translated into a rapid expansion of gross external debt to over 80 percent of GDP in

2004, up from 55 percent in 2001.[1] At the same time, net external debt increased at a much slower pace, to 26 percent of GDP (Figure 2).

Box 1. Article IV Fund Policy Advice Implementation

Estonia has had an excellent working relationship with the IMF since becoming a member in May 1992.[1] The Fund's assistance has been gauged to fit Estonia's needs during various phases of the country's development. Initially, during a period of stabilization, the IMF provided policy advice and financing; more recently the Fund has provided extensive technical assistance while continuing with policy advice in the run up to EU accession. Most Fund policy advice was taken on board and its implementation has been characterized by a high degree of ownership, something that has proved critical in Estonia's successful transformation into a market economy.

However, more recently, fiscal policy has been easier than advised by the Fund and has not contributed to a needed restraint in aggregate demand and a curbing of inflationary pressures.

Estonia is generally at the forefront with issues of transparency and good governance. In response to Fund advice, they have pledged to refrain from all off budget transactions, which, while legal, are non-transparent.

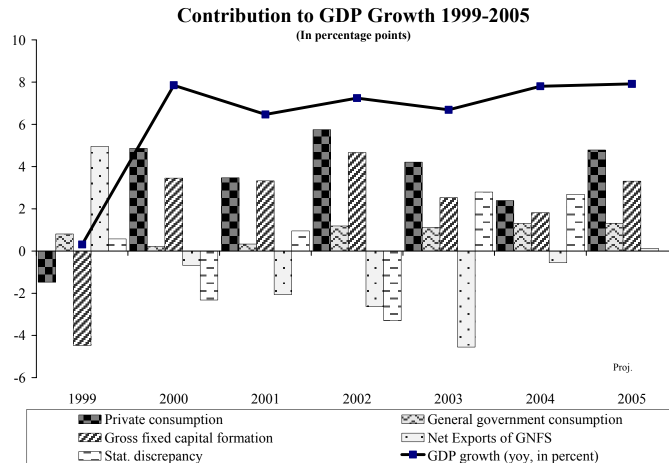
---

[1] For a detailed discussion of the history of Estonia's relations with the IMF see "The IMF and the Baltics: A Decade of Cooperation," by Adalbert Knoebl and Richard Haas, IMF WP/03/241.

---

[1] Two-thirds of gross external debt (excluding inter-company lending to FDI offspring/partners) is undertaken by highly rated and heavily capitalized commercial banks. Only about one third of this debt is short term in nature. The total amount of foreign borrowing by "other" sectors (households, non-bank financial institutions and non-financial enterprises) was equal to 7 percent of GDP at the end of 2004. Trade credits accounted for the bulk of this but were more than covered by the "other" sector's assets.

3. **Robust economic growth continues, largely driven by domestic demand.** Aided by declining real interest rates and large EU grants, real GDP growth increased to nearly 8 percent in 2004 from 6¾ percent a year earlier (Table 1). Growth continued to increase in the first half of 2005, reaching 8½ percent year-on-year. Relatively buoyant economic activity in the Nordic countries, Estonia's main trading partners, resulted in high export growth despite sluggish demand in the rest of the EU.



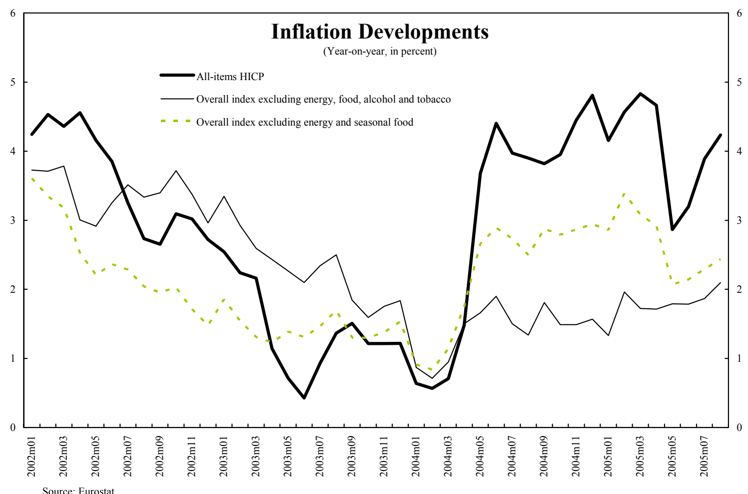
Selected Indicators, 1999-2007
(In units as indicated)

	1999	2000	2001	2002	2003	2004	2005 Proj.
Real GDP (year-on-year in percent)	0.3	7.9	6.5	7.2	6.7	7.8	7.9
Private consumption	-2.6	8.8	6.2	10.3	7.4	4.2	8.6
General government consumption	3.9	1.0	1.6	6.2	5.9	6.9	7.0
Gross fixed capital formation	-15.6	14.3	13.0	17.2	8.5	6.0	11.1
Exports	0.8	28.4	-0.2	0.8	5.8	16.0	14.4
Imports	-5.4	28.1	2.1	3.8	10.6	14.6	12.6
Net exports 1/	5.0	-0.7	-2.1	-2.6	-4.6	-0.6	0.1
Statistical descrepancy 1/	0.6	-2.3	1.0	-3.3	2.8	2.7	0.0
Average CPI (year-on-year in percent)	3.3	4.0	5.8	3.6	1.3	3.0	4.0
Unemployment rate (ILO definition, percer	12.2	13.7	12.6	10.3	10.0	9.7	9.0
Fiscal Balance (in percent of GDP)	-4.3	-0.6	0.4	1.4	2.9	1.7	0.4
Current Account Deficit (in percent of GD	4.4	5.5	5.6	10.2	12.1	12.7	11.1

Sources: Estonian authorities and Fund staff estimates.

1/ Contribution to growth, in percentage points.

4. **Inflation has increased since mid-2004 and remains significantly above the Maastricht criterion.** Headline inflation accelerated to 5 percent, year-on-year, in March 2005 from just below 1 percent at the beginning of 2004, driven by rising energy prices, price increases related to EU accession, and a jump in food prices. Although headline inflation has since declined to 4.2 percent—and is expected to retreat further by year-end, as the initial effects of EU accession-



related price increases wane—it is still forecast to remain above the Maastricht criterion in 2005 and, indeed, with current policies, also by the time of the earliest possible test date in mid-2006. Measures of core inflation, however, are somewhat more reassuring, suggesting that inflationary pressures may abate in the future. Specifically, inflation excluding energy and seasonal food prices has risen much less—about 3 percent year-on-year—while inflation excluding energy, food, alcohol and tobacco prices has remained flat at around 2 percent since early 2004.

5. **With output estimated to be close to potential, sharp wage growth in the first half of 2005, combined with signs of labor shortages in the construction sector and an overall decline of unemployment, could signal nascent overheating.** Wages increased 11 percent in the second quarter of 2005. The unemployment rate, according to the harmonized EU definition, declined by 1.9 percentage points to 8.1 percent in 2005Q2, while overall employment continued to increase.

6. **The current account deficit has widened further, increasing external vulnerabilities.** Despite strong export growth—goods exports grew 17½ percent in volume terms in 2004—the current account deficit increased to 12.7 percent of GDP in 2004 from 12.1 percent in 2003 (Table 2). This reflected a fall in the public sector saving rate combined with a further, though small, decline in private sector saving, with domestic investment remaining robust (Table 3). Strong export performance in the first half of 2005, however, resulted in a substantial improvement of the current account, with the deficit declining to 10.4 percent of GDP.

Measures of Current Account
(In percent of GDP)

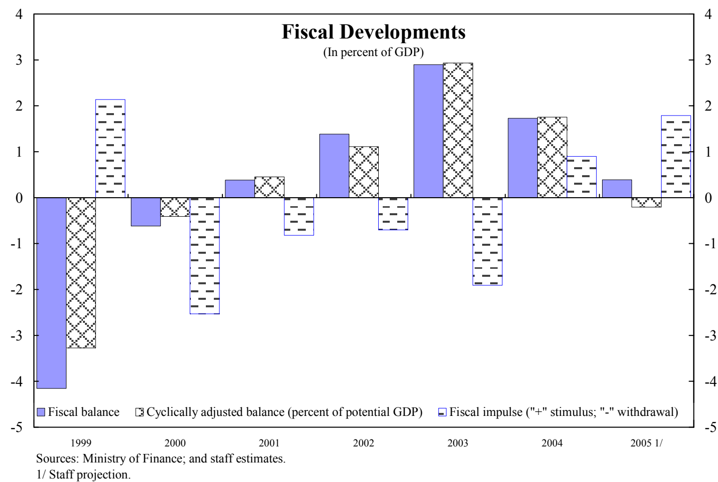
	2000	2001	2002	2003	2004	2005 Proj
Current Account	-5.5	-5.6	-10.2	-12.1	-12.7	-11.1
Primary Current Account /1	-2.9	-1.5	-7.3	-7.1	-6.4	-5.5
Interest	-0.7	-0.7	-0.6	-0.5	-0.6	-0.9
Reinvested earnings	-1.9	-3.4	-2.3	-4.4	-5.7	-4.7
Memorandum item						
External balance (current plus capital accounts)	-5.2	-5.6	-9.9	-11.6	-11.9	-10.4

Source: Estonian authorities.

1/ Excluding interest payments and reinvested earnings.

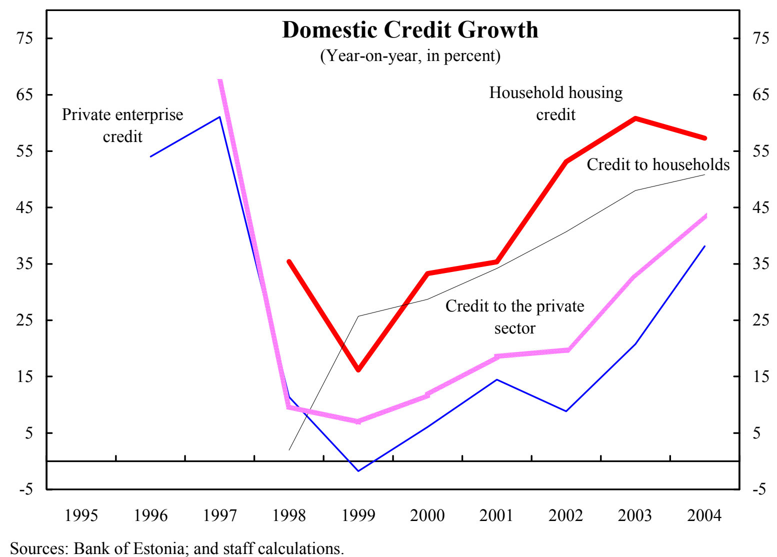
7. **Following four years of conservative fiscal policy, the fiscal stance eased in 2004, and the fiscal surplus is projected to decline further in 2005.** There was substantial over-performance of revenue in 2003 and, with the more-rapid-than-advised unwinding, a significant expansionary fiscal impulse in 2004. The fiscal surplus (on a cash basis) declined to 1.7 percent of GDP from 2.9 percent in 2003 (Table 4) as the government increased

expenditures in a supplementary budget in late 2004 and revenues decreased—temporarily—because of a one month deferral of VAT related to EU accession (about ½ percent of GDP). Developments for the first half suggest that the fiscal surplus will decline further in 2005, despite stronger-than-budgeted revenues, as higher pension expenditures are planned for the second half of the year, and a recent supplementary budget allocates a good part of revenue overperformance to additional spending.



Sources: Ministry of Finance; and staff estimates.
1/ Staff projection.

8. **The rapid expansion of credit to the private sector continued in 2004 and the first half of 2005, financed increasingly by borrowing from abroad.** Domestic banks have funded their operations both by borrowing from their foreign parent banks as well as by issuing foreign currency denominated securities on international markets. Credit growth to households accelerated to above 50 percent in 2004, year-on-year, and the stock of credit has reached nearly 25 percent of GDP, the highest among the new EU8 members. Household loans for real estate accounted for over 80 percent of this: the number of residential dwellings completed—and their prices (unadjusted for quality changes)—have nearly tripled between 2000 and 2004. Credit growth to enterprises accelerated to 48 percent at end-June 2005 from around 25 percent a year earlier, with one-half of all lending to non-financial enterprises channeled into real estate, leasing, and business activities. As a result, credit to the private sector, as a percent of GDP, and its growth rate, remained somewhat above the trend implied by Estonia's income level (Figure 4).



Sources: Bank of Estonia; and staff calculations.

9. **The largely foreign owned banking system remains financially sound, with strong profitability continuing despite increased competition.** The risk weighted capital-adequacy ratio, while recently declining, remains well above the 10 percent requirement (Table 5). Spreads of loan/deposit rates tightened due to increased competition from newly established banks. Despite lower margins, bank profits continued to be strong as loan volumes grew. Non-performing loans remained all but nonexistent at about 0.2 percent of total loans.

Estonia: Selected Financial Indicators, 2000-05

	2000	2001	2002	2003	2004	2005		
						May	June	July
	(In percent of total deposits)							
Banking sector reserves	23.2	13.6	11.2	13.5	16.2	15.6	15.0	15.9
Cash	3.7	3.1	2.7	2.6	2.2	1.7	1.8	1.6
Required reserves	15.9	16.3	16.7	20.5	26.6	26.1	26.4	25.8
Reserves held at the BoE 1/	19.6	10.5	8.6	11.0	14.0	13.8	13.2	14.2
Average risk-weighted capital adequacy ratio	13.2	14.4	15.3	14.5	13.4	12.4	10.9	12.2
Non-performing loans (in percent of total loa	1.0	1.3	0.8	0.4	0.3	0.3	0.2	0.2
Leverage ratio 3/	6.6	6.6	7.3	8.1	9.8	10.3	10.1	10.3

Sources: Bank of Estonia; and Fund staff estimates.

1/ Banks must meet reserve requirements on the basis of average reserve holdings over each reporting period. End of period levels can, therefore, be below the level of required reserves. Starting in January 2001, 3 percentage points of the 13 percent reserve requirement could be met with high quality euro-denominated foreign instruments. In July 2001, this foreign share of reserve requirements was raised to 50 percent.

2/ Non-performing loans are defined as loans overdue from 30-150 days and under current regulations all non-performing loans over 150 days are written off.

3/ Defined as the ratio of total liabilities to total capital; a decline in the ratio indicates improvement.

10. **Confidence in the currency board remains strong and Estonia's entry into ERM II has been uneventful.** Estonia's credit rating was upgraded in mid-2004 by Fitch to A from A- following upgrades by both Moody's and S&P in 2002 (Table 6) and is one of the highest among the new EU members.

II. Report on the Discussions

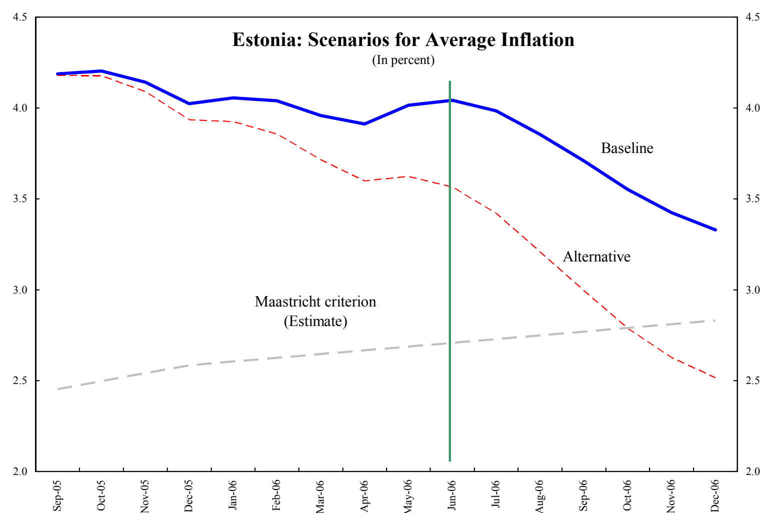
11. **The discussions focused on policies required to maintain macroeconomic stability in the run-up to euro adoption and thereafter.** There was general agreement that the challenge of macroeconomic policies over the near term is to limit risks in the external and financial sectors and to minimize possible inflationary pressures in order to ensure the timely adoption of the euro, with staff seeing a need for greater fiscal restraint. Over the medium to longer term, the goal of policy was seen as supporting sustainable real convergence by preserving external competitiveness and maintaining the flexibility of the Estonian economy.

A. Economic Outlook and Risks

12. **The authorities viewed the macroeconomic outlook in the short term as favorable, but with some upside risk for inflation.** They project real GDP growth of at least 6.5 percent in 2005-06, driven largely by domestic demand with support from the external sector, although the latter is subject to some uncertainty. Average headline inflation is forecast to accelerate to about 3½ percent in 2005—from 3 percent in 2004—as a result of rapidly growing energy prices, increases in administered electricity prices, and EU-related increases in tobacco and fuel excises. 2006 inflation is forecast to decline to 2.6 percent by

the end of the year. However, they recognized that there are upside risks to their inflation forecast which they see coming mainly from higher-than-expected energy prices and possible increases of administered prices by local governments. The authorities also acknowledged that further fiscal stimulus could fuel second-round effects from these supply shocks and result in higher inflation in 2006 when Estonia could be evaluated for full EMU entry membership. The current account deficit is projected to decline to 10½ percent of GDP in 2005 as private saving, aided by increased participation in the second-pillar of the pension system, is forecast to rebound.

13. **This inflation outlook means that it is unlikely that Estonia will meet the Maastricht criterion by June 2006,** the earliest possible test date. The chart below shows the baseline forecast and an alternative, more optimistic forecast where inflation is 0.1 percent a month less than in the baseline. Even under the more optimistic scenario, the estimated inflation criterion would not be met before October 2006. However, in the view of both the authorities and staff, this is neither a cause for undue alarm, nor should it be viewed as a set-back. The Maastricht criterion aside, inflation is decreasing toward a low core rate, and the inflation differential in Estonia is largely a by-product of real convergence. Furthermore, accession related factors themselves account for part of the explanation as to why inflation is higher than in established EU members with relatively low inflation. It is also worth noting that markets have not been perturbed by a possible delay in adopting the euro.[2]



14. **Over the medium term, the authorities expect generally positive macroeconomic developments.** They forecast real GDP growth to remain close to potential at around 6 -7 percent. The current account deficit is projected to decline to about 6 percent of GDP by 2010 (from 12.7 percent in 2004), driven by higher private saving. In their baseline scenario, the authorities forecast headline inflation at around 2½ percent over the medium term.

15. **Staff broadly agreed with this assessment, but saw the risks stemming from inflation and slower external growth.** The main near term risk is inflation, while high

---

[2] A selected issues paper studies inflation dynamics in Estonia and the other EU new member states.

external imbalances and growing foreign indebtedness, especially when used to finance mortgages, pose risks over the medium term. Upward risks to inflation are significant and come from the continuing high growth of energy prices and further wage pressures. Regarding external imbalances, a worsening of economic activity in its main trading partners could reduce growth and widen the current account deficit.

B. Fiscal Policy

16. **The 2005 budget is projected to have a slight surplus, on the order of 0.4 percent of GDP.** In that there was a large surplus of 1.7 percent of GDP in 2004, this will impart a fiscal stimulus equal to about 1¼ percent of GDP. As in the past, revenues appear to have been stronger than budgeted, the result of higher-than-forecast growth. In previous years this led to supplementary budgets in which much of the tax windfall was not spent, but rather used to acquire financial assets. Staff advised that the 2005 supplementary budget do the same. This would have kept the fiscal position broadly unchanged and not injected an ill-timed and unnecessary stimulus to an economy showing signs of overheating. The authorities acknowledged the prudence of such a policy. However, subsequent to the mission, they announced a supplementary budget that will increase spending by about 1 percent of GDP with an amount equal to about 0.4 percent of GDP being saved.

17. **The new coalition government has committed itself to several expenditure and revenue initiatives within the context of a balanced budget.** Beginning in 2006, the new coalition agreement envisages a further increase in the levels of the basic pensions and higher maternity benefits (the latter to be increased to 15 from 12 months). The authorities maintained that the planned pension increase, the major item in the additional spending package, would be financed by a combination of recently revised upward projections of social tax collections and a somewhat smaller-than-expected number of pensioners. To provide the additional financing required for these new spending initiatives, the coalition has agreed on two revenue measures. First, they intend to slow the pace of the previously announced income tax rate reduction to 1 percentage point annually from the current 2 percentage points. This would delay the reduction of the income tax rate to 20 percent from the current 24 percent until 2009. Second, the authorities intend to increase dividend payments from government-owned Estonian Energy and Estonian Telecom. Initially the authorities planned to accelerate the scheduled increase in excise taxes to gain additional revenue, but, in the course of the discussions, decided, because of its inflationary impact, to postpone this until after the adoption of the euro. However, they also emphasized that should the expected additional revenues not cover the entire package of new expenditures, other spending would be cut to balance the budget.

18. **Given the additional expenditures planned by the new government, staff saw the proposed slower path of cuts in income tax rates as appropriate in limiting macroeconomic imbalances.** However, it pointed out that the additional revenue measures considered by the authorities to finance their new spending initiatives could have adverse side effects. In particular, higher dividend withdrawals might be counterproductive at a time when Estonian Energy requires significant investment funds in order to upgrade its

technology. The authorities maintained that the future investment needs of the energy and telecommunications companies would not be undermined. Regarding Estonian Telecom, the authorities pointed out that this would not hurt the company's investment plans because it is a mature firm with few investment needs.

19. **An annually balanced budget is part of the coalition agreement; indeed, this has also been the policy of previous governments.** Difficulties with this approach emerge when the economy is growing above its potential rate. In this case, a balanced budget is pro-cyclical and exacerbates macro imbalances. Thus staff argued, as it has in the past, that the budget be balanced over the cycle and the automatic stabilizers be allowed to operate. And, given that the 2005 budget at the time of the mission was projected to be in strong surplus, staff recommended that a balanced budget be targeted only over the medium term—and consequently the surplus be lowered gradually—so as not to be pro-cyclical. In addition, staff noted, a gradual reduction of fiscal surpluses over the next several years would provide an opportunity to better provision for the future needs of Estonians. The authorities argued that the balanced budget target was appropriate, given the low level of public debt, and maintained that it would be difficult to justify to the public the need for continued fiscal surpluses over the medium term. Staff agreed that, from a debt sustainability viewpoint, the target appeared appropriate over the longer term, but saw a short-term need for fiscal restraint to reduce external vulnerabilities and support the adoption of the euro.

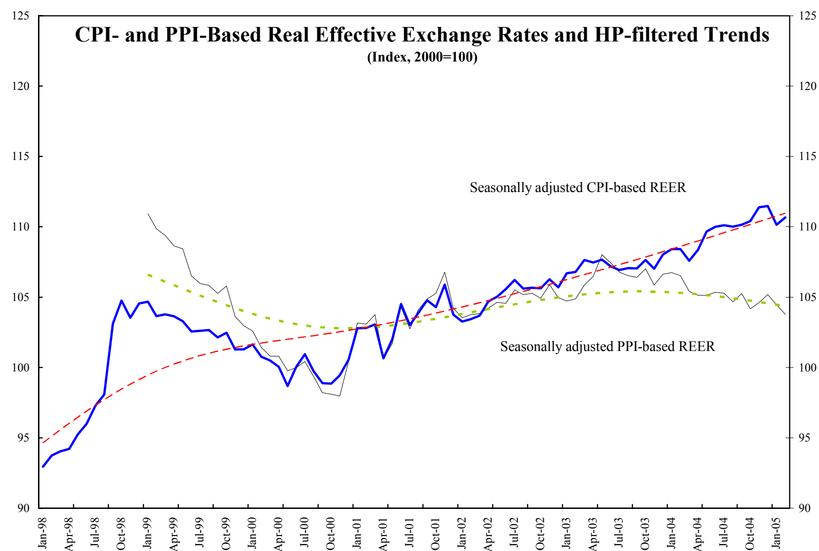
20. **The authorities voiced resolve in introducing medium-term budgeting for the next budget cycle in order to improve expenditure control and maintain fiscal prudence.** This approach was suggested by a recent FAD TA mission. Given the increase in the size of the government over the past several years, staff welcomed this, especially in light of growing demand for healthcare services in Estonia's aging population. Staff also noted that the government's wage bill has increased significantly (by around 1 percent of GDP) in recent years, reflecting large increases in both health and education employment, as well as sizeable increases in healthcare wages this year. However, the authorities pointed out that part of the expenditure increase was due to EU related spending, and that the growth of wages in the public sector was not excessive, if adjusted for education level differentials with the private sector.

C. Financial Policy and Euro Adoption Issues

21. **The authorities shared staff concerns about the high growth rate of credit.** However, they pointed out that, to a great degree, the boom in credit is a result of Estonia's sound macroeconomic development, the decline in real interest rates, improved external credit ratings, and financial deepening. They also noted that credit conditions in the Euro-area were looser than conditions in Estonia warranted. While agreeing with this assessment, staff noted that fast credit growth could spur inflationary pressures. Furthermore, it argued that continued high credit growth rates had stimulated a rapid expansion of the real estate sector and, given that real estate lending is largely financed from abroad, contributed to external risks.

22. **The authorities stressed their readiness to use all available tools, including prudential regulations, to safeguard credit standards.** They pointed out that levels of credit in Estonia were low by EU standards and financial stability indicators remained sound, with risk adjusted capital adequacy ratios well above the required 10 percent, and non-performing loans close to zero. The authorities also noted that periodic, forward-looking stress tests of the banks' balance sheets both by the Financial Supervisory Authority, as well as by the banks themselves, indicate that the banking system is sound. Staff agreed but noted that there were signs of overheating in the real estate market, as evidenced by strong mortgage demand and developing labor shortages in the construction sector. Therefore, staff suggested consideration be given to further reducing mortgage interest deductibility and to maintaining the limits on the housing activities of Kredex—a quasi-government loan guarantee agency—to restrain the growth of housing demand.

23. **The authorities pointed out that the strong performance of exports and broadly stable traded goods prices suggest that the current exchange rate peg was appropriate.** Estonia's external competitiveness remains relatively strong (Figure 3). Market shares of Estonian exports in both world and EU markets increased in 2004. With respect to relative cost measures, the economy-wide unit labor cost-based real effective exchange rate has remained broadly unchanged since 1999, the CPI-based real effective exchange rate has appreciated on average by about 2 percent a year, in line with estimated Balassa-Samuelson effects, while the PPI-based real effective exchange rate has stayed roughly flat. The authorities also acknowledged the importance of labor market flexibility in the context of the currency board in maintaining Estonia's competitiveness over the past decade. Staff agreed with this assessment and noted, in light of the continuing high current account deficits and given the currency board arrangement, that maintaining labor and product market flexibility is vital in preserving Estonia's competitiveness over the medium term and ensuring sustainable real convergence in the run-up to euro adoption and thereafter.



24. **Discussions on euro adoption covered several technical issues.** First, it will be necessary for Estonia to harmonize its reserve requirements with EU norms. Neither the authorities nor staff saw lowering reserve requirements, from 13 percent to 2 percent, as causing any insurmountable liquidity problems. Owing to the availability of funds from foreign parent banks and access to external borrowing, changing reserve requirements on

domestic deposits will not materially alter liquidity. Second, the possible need for a constitutional amendment to give the government the power to declare the euro legal tender has been raised in Brussels. The authorities argued against the need for a constitutional amendment which would involve delaying adoption of the euro and felt that an amendment to the Bank of Estonia Law that makes it clear that the euro is the legal currency of the country would be sufficient to remove any doubt on this issue.

25. **The authorities acknowledged the risks associated with the high current account deficit and the rapid accumulation of gross external debt, but saw the external position improving over the medium term.** Their argument was twofold. First, the high level of FDI in Estonia over past years is expected to result in robust export oriented growth over the medium term. Second, saving is expected to increase, supported by the growing second pillar pension fund and a decline in consumption smoothing, as income levels continue to increase. They noted also that conventional indicators suggest that Estonia's vulnerability to a crisis was similar to that in the other Baltic countries (Table 8) and net external debt was not excessive.[3] Moreover, they pointed out that the major banks had treasury mandates with their parents that significantly reduce rollover risks. Staff agreed with this assessment, but pointed out that, nevertheless, risks remain. In the staff's baseline scenario, gross external debt is forecast to rise initially to around 90 percent of GDP, before declining gradually to 84½ percent of GDP by 2010 (close to its 2004 level), with net debt at roughly half those levels (Tables 2 and 7)[4]. Staff pointed out that if the expected rebound in private saving did not materialize, the outlook would be less sanguine. The alternative scenario (Table 9) attempts to quantify this by assuming that consumption, met by imports, continues at a high level. In this case, a higher external debt path results (above 90 percent) in the medium term. Thus external vulnerabilities increase, as does the likelihood of a hard landing.

D. Structural and Other Issues

26. **The authorities saw labor market conditions improving further.** They maintained that while structural unemployment, in part a legacy of Estonia's central planning past, remained high, it was localized. The authorities pointed out that in addition to buoyant economic activity, the active labor market policies introduced in autumn 2004 were also seen as contributing to declining unemployment. The new vocational education development strategy for 2005–08 has been expanded and Estonia has prepared for the future use of EU

[3] A selected issues paper examines developments in net international investment positions among the EU's new member states.

[4] The level of net external debt has increased on average by 14 percentage points of GDP over the past five years when the amount of foreign assets held by "other" sectors (including pension funds and insurance companies) is excluded, but the dynamics remain broadly unchanged.

structural funds to achieve the goals of the plan. This should improve labor market performance.

27. **Reforms to increase effective competition in network industries continue, albeit at a measured pace.** Progress in reforming the electricity sector continues on schedule; in light of Estonia's heavy reliance on domestic shale-oil resources, it was granted (under the EU accession treaty) a transitional period lasting until the end of 2012 before complete opening of the electricity market. The telecommunication market has experienced rapid growth following its liberalization in 2003 with recent measures, including mobile phone number portability, further increasing competition.

28. **The authorities reported that legislation to combat money laundering and the financing of terrorism has been implemented in accordance with international norms.** Estonia's anti-money laundering legislation was brought in line with the latest EU directives in this area; Estonia has fully implemented all U.N. Security Council Resolutions regarding the financing of terrorism.

29. **Estonian data are of good quality and do not impede effective surveillance.** The authorities compile fiscal data on cash basis and do not plan switching to accrual basis in the medium term. However, staff noted that quality fiscal data are at the heart of policy formulation and urged the authorities to give a higher priority to adopting the European System of Accounts established in 1995. Staff also suggested that the authorities collect detailed data on the maturity structure of bank assets and liabilities to aid in assessing financial risk.

III. Staff Appraisal

30. **Estonia has made major economic strides since independence.** Sound macroeconomic policies and far-reaching structural reforms have been instrumental in fostering macroeconomic stability and promoting strong growth. As a result, the country is rapidly converging to EU levels. And Estonia is leading most other new EU member states in meeting the Maastricht criteria, although satisfying the inflation criterion remains a challenge. The country entered ERM II in late June 2004, unilaterally maintaining its euro-pegged currency board, and is well positioned to adopt the euro in due course.

31. **While economic developments are generally favorable, the future is not without risks, with nascent signs of overheating in some sectors, and external vulnerabilities mounting.** For a country at Estonia's stage of development, some inflation is to be expected as productivity-led wage increases spread throughout the economy. In a small open economy with a currency board arrangement, inflation is, in large measure, determined by external factors. Notwithstanding this, domestic policy has a role to play. While the core inflation rate is currently low at about 2 percent, an expansionary fiscal stimulus, especially if combined with rapid credit growth, could result in a build-up of inflationary pressure. And vulnerability to external shocks remains, with a relatively large current account deficit that is increasingly financed by borrowing from abroad. Again, for a country in Estonia's position, some current

account deficit is to be expected as the country increases its productive capacity by importing capital equipment. But, at present, the current account deficit is at a level that cannot be maintained indefinitely.

32. **Prudent policies need to be pursued to keep inflation in check, and thereby facilitate the smooth adoption of the euro, and to allow external imbalances to return to sustainable levels.** In the short-term, with the economy near potential and early signs in the real estate and construction sectors that the economy may be facing some bottlenecks, fiscal restraint is called for. This would reduce domestic demand and the external imbalances as well as forestall inflationary pressures. Looking beyond the short-term, maintaining product market and wage flexibility is paramount in preserving Estonia's competitiveness and facilitating convergence.

33. **Given the limitations a currency board places on an independent monetary policy, tight fiscal policy is the only effective major tool available to reduce external vulnerabilities and restrict domestic demand.** However, by reducing a large fiscal surplus to a small one, Estonia has chosen to run an expansionary macro policy in 2005. Should any further revenue windfalls occur, it is important that they be saved. In 2006 the authorities should tighten fiscal policy, run a substantial surplus, and thereby reduce demand pressures in an overheated system. Looking ahead, while a balanced budget appears appropriate from a medium- to long-run perspective, it should be achieved only gradually, with a measured reduction in the fiscal surplus over several years to limit external vulnerabilities and support the timely adoption of the euro. In as much as the recent supplementary budget has reduced the surplus at too rapid a rate, the authorities should reverse enough of this easing to ensure a cyclically neutral stance.

34. **The announced increase of the basic pension in 2006 could put pressure on the fiscal balance despite the higher revenues expected from a slower pace in the reduction of the income tax rate.** The authorities have proposed increasing dividends from state-owned companies, something that might prove counterproductive at a time when significant investment funds are required. Thus, should the pension increase be implemented, sufficient cuts in other expenditures should be taken in order to avoid further fiscal stimulus.

35. **Greater efforts to control government current expenditure are also called for.** The government's wage bill has increased significantly. Controlling expenditure growth, especially in the light of growing demand for healthcare services, should be improved to preserve the relatively favorable tax environment which has clearly been beneficial to Estonia over the past decade. The necessary preparatory work has been completed and medium-term budgeting should be implemented in the next budget cycle. Furthermore, a functioning multi-year budgeting framework could serve as a vehicle to implement a strategy of balancing the budget over the cycle. A move toward general government accrual accounting in the medium term is also recommended.

36. **The high growth rate of credit continues to add to demand pressures.** If banks loosen credit standards in the current period of high growth, financial supervisors should use

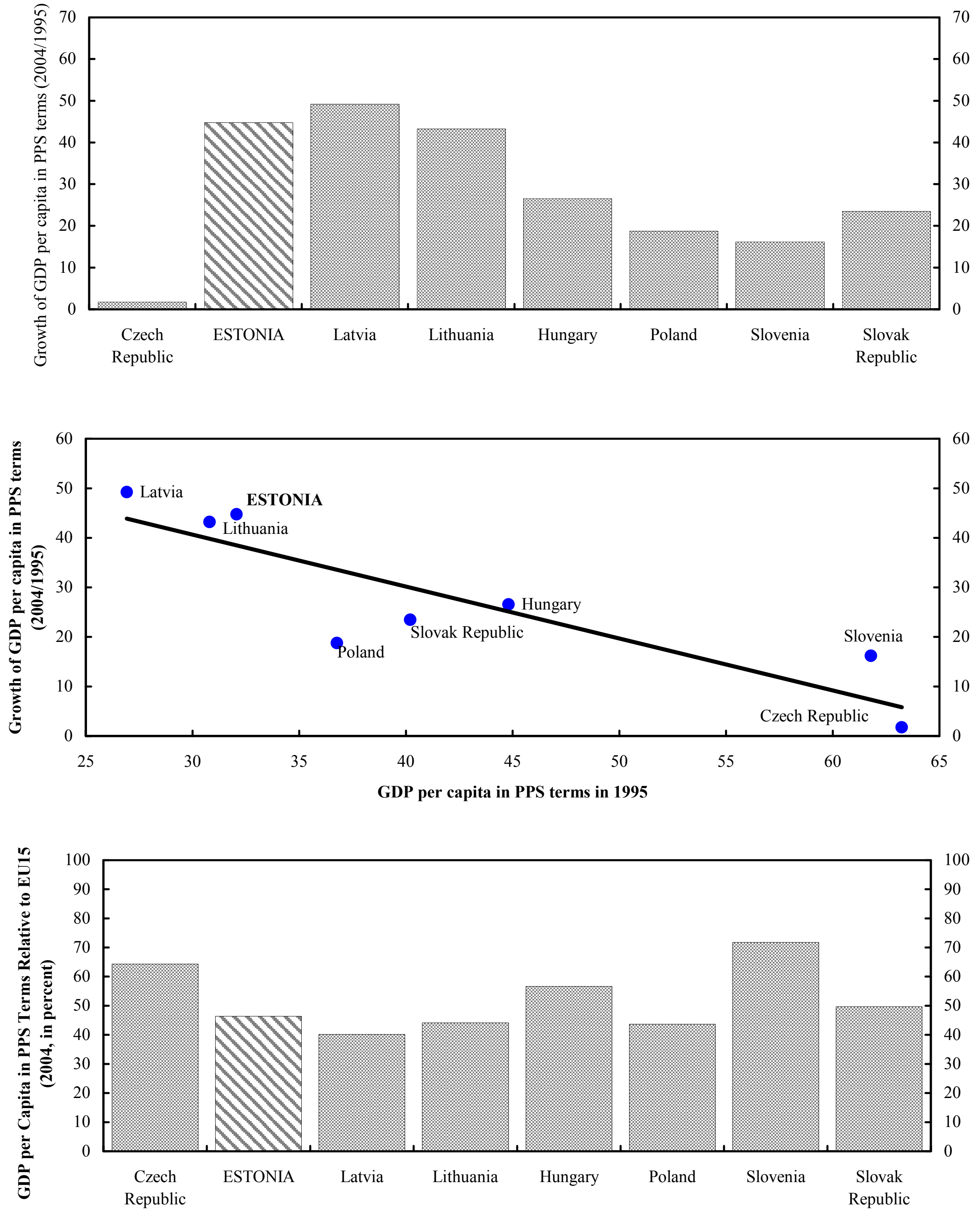
all of the tools at their disposal, including prudential regulations, to ensure the stability of the financial system. While levels of credit in Estonia are low by EU standards—and some relatively rapid credit growth is to be expected as the financial system converges to EU norms—there are emerging signs of overheating. Slowing the growth in housing demand could be achieved by further reducing mortgage interest deductibility and maintaining the current limits on the housing activities of Kredex.

37. **The strong performance of exports and relatively stable traded goods prices suggest that the current exchange rate peg is appropriate.** There is no evidence that the current account deficit reflects a problem in competitiveness. Because Estonia has a currency board arrangement, maintaining labor and product market flexibility is critical in preserving Estonia's competitiveness over the medium term and ensuring sustainable real convergence in the run-up to euro adoption and thereafter.

38. **Establishing a market based system and pursuing prudent macro policies have worked well for Estonia.** The country has enjoyed robust growth and relatively stable prices, achieved EU membership, and entered ERM II. However, full integration into the euro area is not yet complete and the authorities should guard against complacency and continue on the course they have charted for themselves.

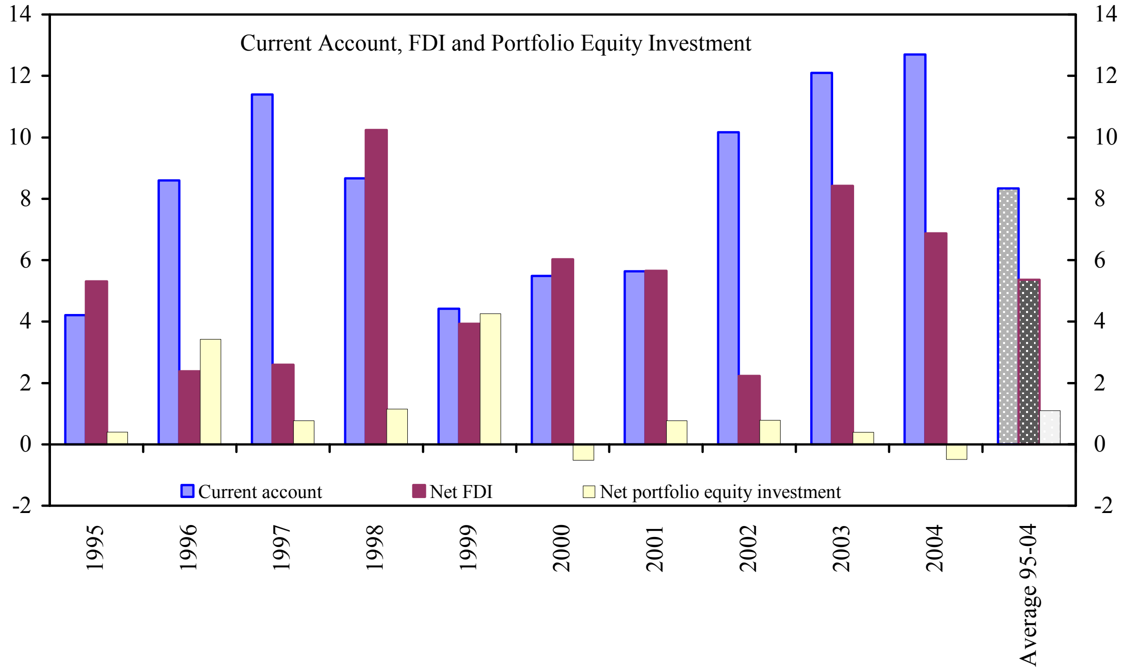
39. It is recommended that the Article IV consultation with Estonia remain on the standard 12-month cycle.

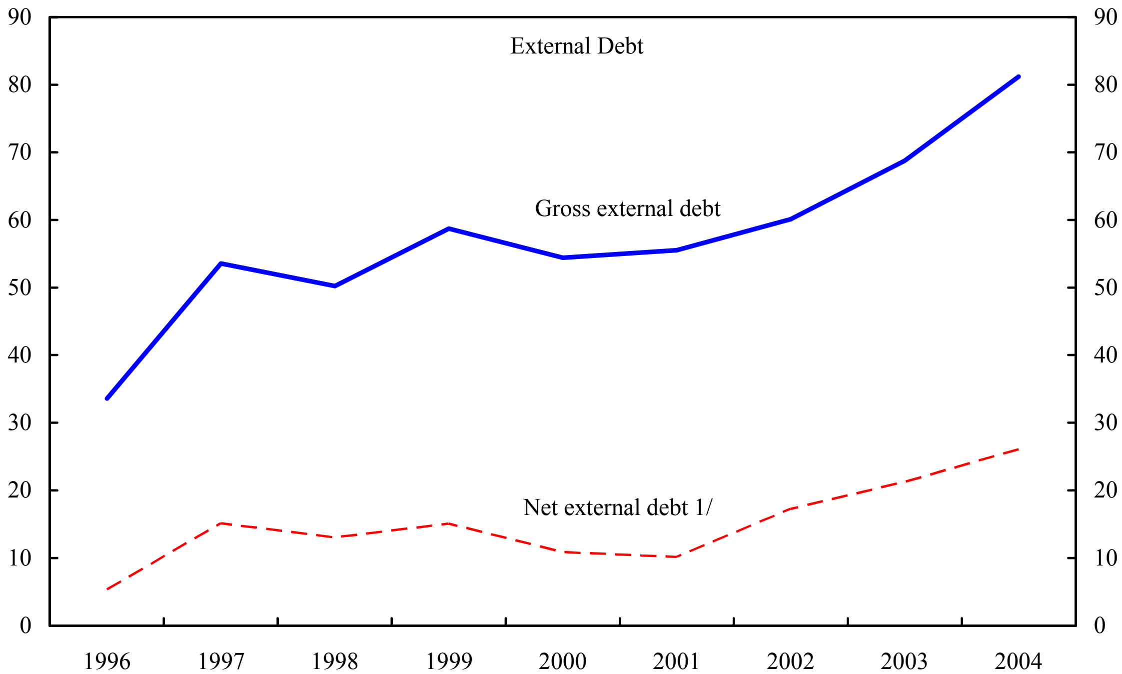
Figure 1. New EU8 Member States: Progress in Income Convergence to EU15
(GDP per capita in Purchasing Power Standards (PPS))



Source: Eurostat.

Figure 2. Current Account, FDI, and External Debt
(In percent of GDP)





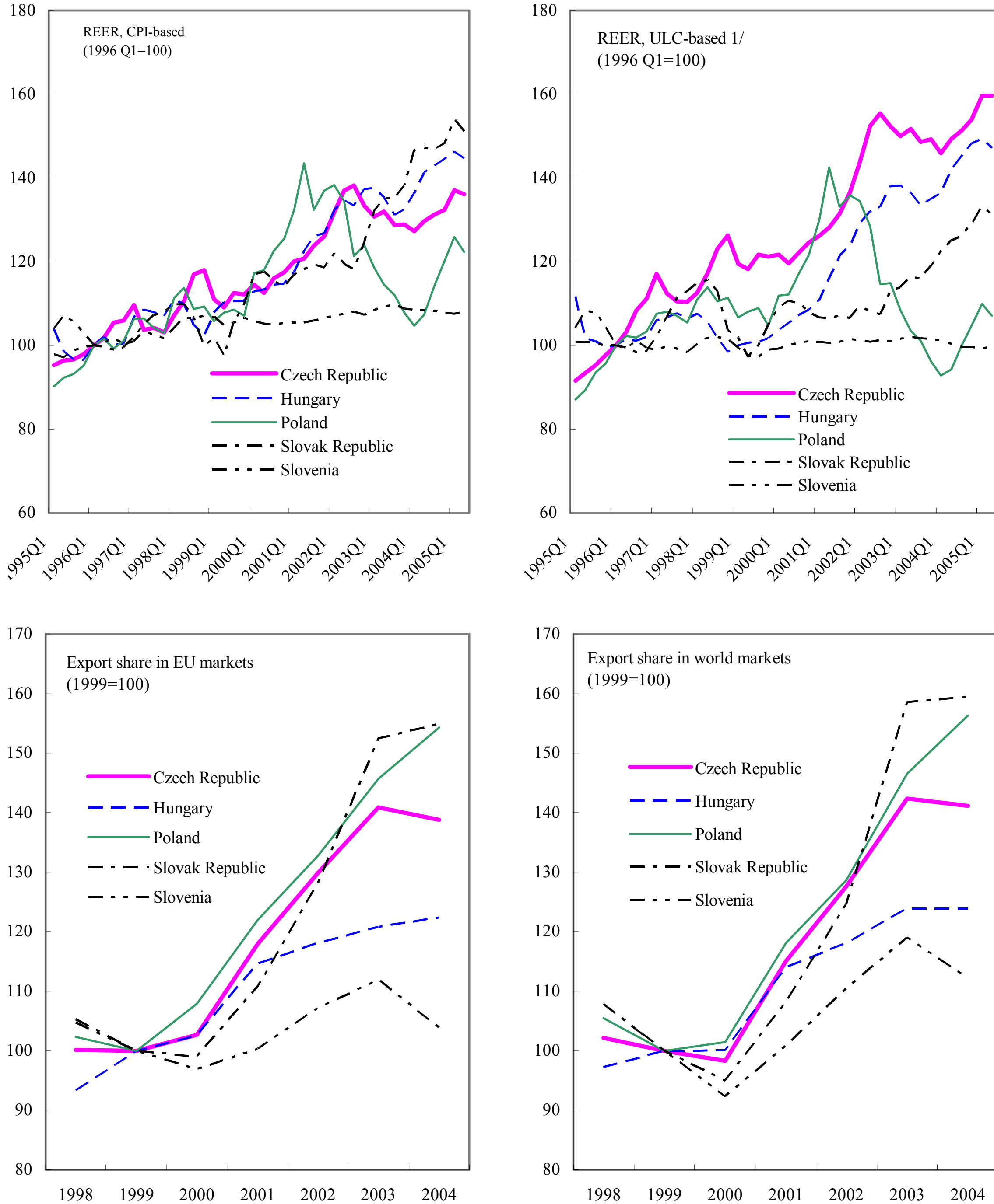
Source: Estonian authorities.

1/ Net of portfolio, financial derivative, other investment, and reserve assets held by Estonian residents.

Figure 3. New EU8 Countries: Real Effective Exchange Rates and Export Penetration, 1995–2005

Sources: Country authorities; Eurostat; Direction of Trade; and International Financial Statistics.
1/ Economy wide.
2/ The data for 2000 is atypical due to transitory boom in electronic goods assembly.

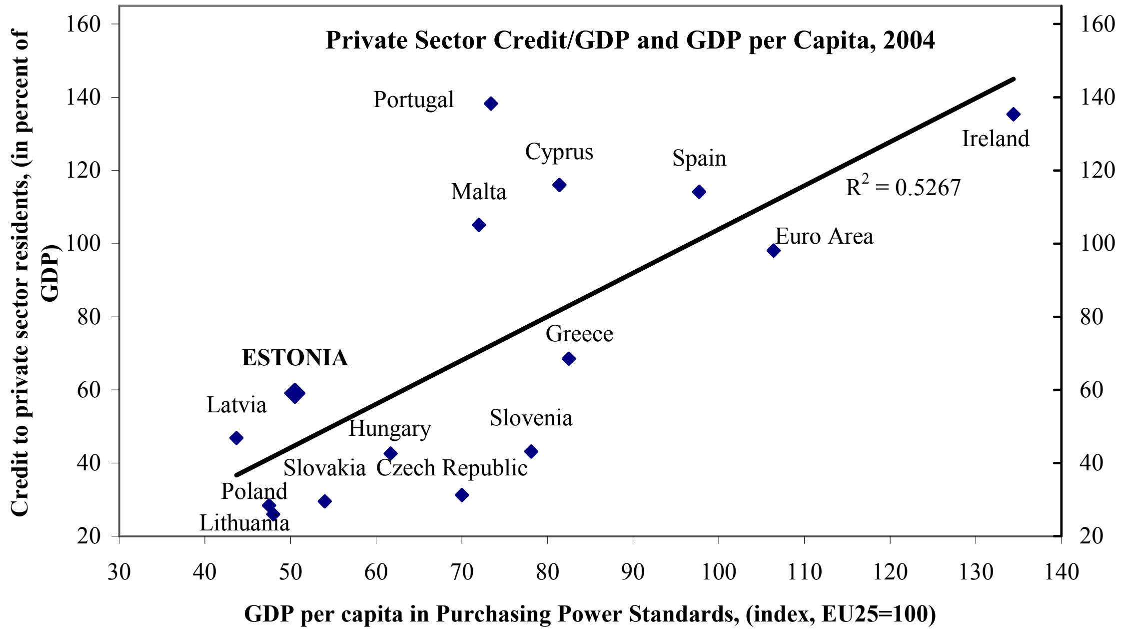
Figure 3. New EU8 Countries: Real Effective Exchange Rates and Export Penetration, 1995-2005 (Concluded.)

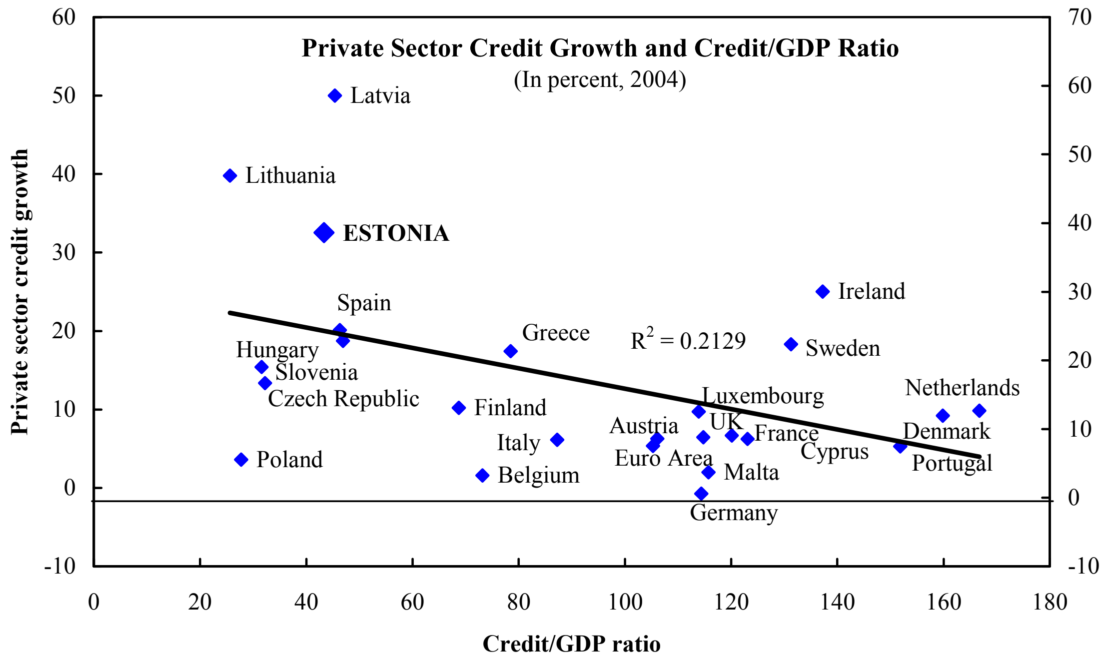


Sources: Country authorities; Eurostat; Direction of Trade; and International Financial Statistics.

1/ Economy wide, 25 trading partners.

Figure 4. Credit Developments in Estonia and Other EU Countries





Source: Eurostat.

Table 1. Estonia: Selected Macroeconomic Indicators, 2000–06
(In units as indicated)

	2000	2001	2002	2003	2004	2005	2006
						Proj.	
National income, prices and wages							
Nominal GDP (kroons, millions)	92,938	104,459	116,915	127,334	141,493	159,570	175,671
GDP (euro, millions)	5,940	6,676	7,472	8,138	9,043	10,198	11,227
Real GDP growth (year-on-year in percent)	7.9	6.5	7.2	6.7	7.8	7.9	6.5
Private consumption	8.8	6.2	10.3	7.4	4.2	8.6	6.2
General government consumption	1.0	1.6	6.2	5.9	6.9	7.0	5.0
Gross fixed capital formation	14.3	13.0	17.2	8.5	6.0	11.1	8.0
Exports	28.4	-0.2	0.8	5.8	16.0	14.4	8.4
Imports	28.1	2.1	3.8	10.6	14.6	12.6	8.0
Net exports 1/	-0.7	-2.1	-2.6	-4.6	-0.6	0.1	-0.5
Statistical descrepancy 1/	-2.3	1.0	-3.3	2.8	2.7	0.0	0.0
Average CPI (year-on-year change in percent)	4.0	5.8	3.6	1.3	3.0	4.0	3.4
12-month CPI (end of period change in percent)	5.1	4.2	2.7	1.1	5.0	3.6	2.6
GDP deflator (year-on-year change in percent)	6.7	5.2	4.4	2.1	3.1	4.5	3.4
Average monthly wage (end-of-period, euro)	312	352	390	428	462	485	509
Unemployment rate (ILO definition, percent)	13.7	12.6	10.3	10.0	9.7	9.0	8.5
Saving-investment balances (in percent of GDP)							
Domestic saving	22.3	23.5	21.6	19.9	18.5	20.1	20.6
Private	20.0	20.1	16.9	14.2	13.9	16.3	17.9
Public	2.3	3.4	4.7	5.7	4.6	3.7	2.8
Domestic investment	27.8	29.2	31.8	32.0	31.2	31.2	31.0
Private	24.8	26.1	28.2	29.2	28.3	27.8	28.2
Public	2.9	3.0	3.6	2.8	2.9	3.4	2.8
Foreign saving	5.5	5.6	10.2	12.1	12.7	11.1	10.4
General government (in percent of GDP)							
Revenue and grants	35.6	35.3	36.9	38.1	38.8	39.9	39.1
Expenditure and net lending	36.2	34.9	35.5	35.2	37.1	39.5	39.2
Fiscal balance	-0.6	0.4	1.4	2.9	1.7	0.4	0.0
External sector (euro, millions)							
Trade balance	-840	-881	-1150	-1373	-1585	-1559	-1684
Service balance	612	649	618	753	878	856	963
Current account	-326	-376	-759	-984	-1148	-1131	-1167
Gross international reserves (euro, millions) 2/	992	930	958	1098	1317	1421	1514
in months of imports	2.7	2.4	2.4	2.4	2.5	2.3	2.2
Relative to gross short-term debt (including trade credits)	0.8	0.7	0.6	0.6	0.6	0.6	0.6
Gross external debt/GDP (in percent) 3/	54.4	55.5	60.1	68.7	81.2	84.6	87.8
Net external debt/GDP (in percent) 4/	10.9	10.2	17.3	21.3	26.1	30.5	35.0
General government external debt/GDP (in percent)							
Excluding government assets held abroad	3.5	2.9	2.9	2.9	2.7	2.4	2.2
Including government assets held abroad 5/	1.6	-0.6	-2.6	-5.5	-5.4	-4.8	-4.3
Exchange rate (EEK/US$ - period average) 6/	17.0	17.5	16.6	13.9	12.6	…	…
Money and credit (year-on-year growth in percent)							
Domestic credit to nongovernment	30.3	22.2	27.8	27.0	31.2	36.3	28.8
Base money	14.6	-9.8	-1.5	14.6	24.0	13.4	15.6
Broad money	25.7	23.0	11.2	10.9	15.8	29.8	17.1

Social indicators (reference year) **population** (2000): 1.3642 million; **per capita GDP** (2004): €6,629
life expectancy at birth (2001): 76.4 (female) and 65.1 (male)

Sources: Estonian authorities, and Fund staff estimates and projections.

1/ In percentage points.
2/ Lower reserve requirements introduced in 2001 have led to a decline in international reserves under the mechanics of the currency board, which was more than compensated by the improvement in the net foreign asset position of commercial banks. In addition, net short term debt of the banking system has become negative.
3/ Includes trade credits.
4/ Net of portfolio assets (including money market instruments), financial derivative assets, other investment assets, and reserve assets held by Estonian residents.
5/ Government assets held abroad include the Stabilization Reserve Fund (SRF).
6/ Estonian kroon is pegged at 15.6466 kroons to the euro.

Table 2. Estonia: Summary Balance of Payments 2000–10

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
						Proj.					
	(In millions of euro)										
Current Account	-326	-376	-759	-984	-1,148	-1,131	-1,167	-1,154	-1,122	-1,128	-1,143
Primary Current Account /1	-171	-102	-545	-581	-577	-560	-596	-583	-551	-556	-571
Trade Balance	-840	-881	-1,150	-1,373	-1,585	-1,559	-1,684	-1,764	-1,848	-1,992	-2,167
Exports	3,601	3,750	3,713	4,065	4,797	5,829	6,481	7,083	7,737	8,394	9,091
Of which : goods for processing	1,523	1,422	1,144	1,204	801	973	1,081	1,182	1,291	1,401	1,517
Imports	-4,441	-4,630	-4,878	-5,438	-6,382	-7,388	-8,164	-8,847	-9,584	-10,386	-11,258
Of which : goods for processing	-1,374	-1,141	-965	-962	-693	-802	-886	-960	-1,040	-1,127	-1,222
Services Balance	612	649	519	753	878	856	963	1,056	1,157	1,268	1,389
Receipts	1,629	1,845	1,807	1,970	2,275	2,463	2,701	2,934	3,188	3,464	3,764
of which: travel and tourism	549	569	585	591	710	797	874	949	1,031	1,121	1,218
Payments	-1,017	-1,196	-1,289	-1,217	-1,397	-1,607	-1,737	-1,879	-2,031	-2,196	-2,374
Income	-223	-315	-350	-474	-574	-556	-582	-588	-581	-562	-533
Current Transfers	125	170	152	109	133	129	135	142	149	158	167
Capital and Financial Account	480	311	869	1,165	1,435	1,236	1,260	1,245	1,219	1,230	1,251
Capital Transfers	18	6	20	42	67	29	41	41	41	41	41
Financial Account	462	305	848	1,123	1,367	1,206	1,220	1,204	1,178	1,189	1,210
Direct Investment	358	377	167	685	621	389	343	320	307	302	302
From abroad	425	603	307	822	838	617	584	574	575	585	600
Outward (by Estonians)	-67	-225	-140	-137	-217	-228	-241	-254	-268	-283	-299
Net equity investment	-31	51	59	32	-44	64	64	64	64	64	64
Loans and other investments 2/	135	-124	622	407	790	754	812	821	807	823	844
of which:											
Banks	161	-104	340	697	897	748	807	815	801	817	838
Government	12	-133	-142	-211	-43	-43	-43	-43	-43	-43	-43
Monetary Authorities	-8	-13	38	37	11	11	11	11	11	11	11
Errors and Omissions	-9	19	35	-33	-68	0	0	0	0	0	0
Overall balance	145	-47	59	148	219	104	93	91	96	102	108
Memorandum Items:											
EEK/EURO exchange rate (period average)	15.6	15.6	15.6	15.6	15.6	...	...	...	...	...	...
Gross International Reserves (EURO millions) 3/ 4/ :	992	930	958	1,098	1,317	1,421	1,514	1,605	1,702	1,804	1,912
In months of imports	2.7	2.4	2.4	2.4	2.5	2.3	2.2	2.2	2.1	2.1	2.0
Relative to gross short-term debt (ratio) 6/ 7/	0.8	0.7	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
	(In percent of GDP)										
Trade Balance	-14.1	-13.2	-15.4	-16.9	-17.5	-15.3	-15.0	-14.4	-13.9	-13.7	-13.7
Goods and Non-factor Services balance	-3.8	-3.5	-7.1	-7.6	-7.8	-6.9	-6.4	-5.8	-5.2	-5.0	-4.9
Current Account	-5.5	-5.6	-10.2	-12.1	-12.7	-11.1	-10.4	-9.4	-8.4	-7.8	-7.2
Primary Current Account /1	-2.9	-1.5	-7.3	-7.1	-6.4	-5.5	-5.3	-4.8	-4.1	-3.8	-3.6
Income	-3.7	-4.7	-4.6	-5.8	-6.3	-5.5	-5.2	-4.8	-4.4	-3.9	-3.4
Interest	-0.7	-0.7	-0.6	-0.5	-0.6	-0.9	-1.2	-1.6	-1.9	-2.2	-2.5
Reinvested earnings	-1.9	-3.4	-2.3	-4.4	-5.7	-4.7	-3.9	-3.1	-2.4	-1.7	-1.1
Total external debt 8/											
Gross	54.4	55.5	60.1	68.7	81.2	84.6	87.8	89.3	88.8	86.7	84.5
Net 9/	10.9	10.2	17.3	21.3	26.1	30.5	35.0	38.8	41.7	44.0	45.7
General government external debt 10/											
Excluding Govt. assets held abroad	3.5	2.9	2.9	2.9	2.7	2.4	2.2	2.0	1.9	1.7	1.6
Including Govt. assets held abroad	1.6	-0.6	-2.6	-5.5	-5.4	-4.8	-4.3	-4.0	-3.7	-3.4	-3.1
Debt Service/Exports of GNFS (in percent)	6.8	8.0	9.7	11.1	12.5	12.5	12.9	13.1	13.0	12.7	13.5

Sources: Bank of Estonia and Fund staff estimates.

1/ Excluding interest payments and reinvested earnings.
2/ Including operations in debt securities.
3/ Excludes Government deposits held abroad (including in the SRF).
4/ Changes in gross international reserves may differ from flows implied by overall balance of payments due to valuation changes.
5/ Gross international reserves at end-1999 were inflated by banks shifting resources from accounts abroad to the Bank of Estonia to enhance domestic liquidity in anticipation of Y2K-related problems.
6/ Includes trade credits.
7/ Short term debt is defined on the basis of original maturity.
8/ Starting in 2000, the definition of external debt was widened to include money market instruments and financial derivatives.
9/ Net of portfolio assets (including money market instruments), financial derivative assets, other investment assets, and reserve assets held by Estonian residents.
10/ Includes government guaranteed debt.

Table 3. Estonia: Macroeconomic Framework, 2000–10
(in percent of GDP, unless otherwise indicated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
								Proj.			
Domestic saving	22.3	23.5	21.6	19.9	18.5	20.1	20.6	21.5	22.4	23.1	23.8
Private	20.0	20.1	16.9	14.2	13.9	16.3	17.9	18.2	19.1	19.8	20.5
Public	2.3	3.4	4.7	5.7	4.6	3.7	2.8	3.3	3.3	3.3	3.3
Investment	27.8	29.2	31.8	32.0	31.2	31.2	31.0	30.9	30.9	30.9	31.0
Private	24.8	26.1	28.2	29.2	28.3	27.8	28.2	27.6	27.6	27.6	27.7
Public	2.9	3.0	3.6	2.8	2.9	3.4	2.8	3.3	3.3	3.3	3.3
Foreign saving	5.5	5.6	10.2	12.1	12.7	11.1	10.4	9.4	8.4	7.8	7.2
Memorandum items:											
Fiscal balance	-0.6	0.4	1.4	2.9	1.7	0.4	0.0	0.0	0.0	0.0	0.0
Revenues	35.6	35.3	36.6	38.1	38.8	39.9	39.1	39.3	39.0	38.8	38.7
Expenditures 1/	36.2	34.9	35.5	35.2	37.1	39.5	39.1	39.3	39.0	38.8	38.7
Net non-debt creating capital inflows ("+" inflow)	5.5	6.4	3.0	8.8	6.4	4.4	3.6	3.1	2.8	2.5	2.3
Net equity investment	-0.5	0.8	0.8	0.4	-0.5	0.6	0.6	0.5	0.5	0.4	0.4
Net foreign direct investment	6.0	5.6	2.2	8.4	6.9	3.8	3.1	2.6	2.3	2.1	1.9
GDP real growth (year-on-year in percent)	7.9	6.5	7.2	6.7	7.8	7.9	6.5	6.3	6.2	6.2	6.2
CPI inflation (average, year-on-year in percent)	4.0	5.8	3.6	1.3	3.0	4.0	3.4	2.5	2.5	2.5	2.5
CPI inflation (end-period, in percent)	5.1	4.2	2.7	1.1	5.0	3.6	2.6	2.5	2.5	2.5	2.5
GDP (millions of kroons)	92,938	104,459	116,915	127,334	141,493	159,570	175,671	191,490	208,446	226,904	246,997

Sources: Estonian authorities, and Fund staff estimates.

1/ Includes net lending.

Table 4. Estonia: Summary of General Government Operations, 2000–06
(In percent of GDP)

	2000	2001	2002	2003	2004	2005	2006
						Proj.	
Revenue and grants	35.6	35.3	36.9	38.1	38.8	39.9	39.1
Revenue	35.3	34.7	36.3	36.9	36.5	36.7	36.0
Tax revenue	31.6	30.7	32.1	32.5	31.9	32.4	31.7
Direct taxes	19.6	19.0	19.5	20.2	19.8	19.3	18.3
Personal income tax	7.1	6.8	6.7	6.9	6.7	6.2	5.3
Corporate profits tax	0.9	0.7	1.2	1.7	1.8	1.8	1.8
Social security tax	6.8	6.7	6.6	6.4	6.1	6.1	6.0
Medical insurance tax	4.4	4.3	4.3	4.4	4.4	4.4	4.4
Unemployment insurance tax	...	...	0.4	0.4	0.5	0.5	0.5
Land and property taxes	0.4	0.4	0.4	0.3	0.4	0.4	0.4
VAT	8.8	8.3	8.7	8.8	8.0	8.8	9.0
Excises	3.0	3.3	3.4	3.3	3.7	3.9	4.1
Other taxes (incl. on intern. trade)	0.2	0.2	0.5	0.2	0.3	0.3	0.3
Nontax revenue	3.7	4.0	4.2	4.4	4.6	4.4	4.2
Grants	0.3	0.6	0.6	1.2	2.3	3.1	3.1
Expenditure	36.5	35.0	35.6	35.2	37.1	39.5	39.1
Current expenditure	33.6	32.0	32.0	32.4	34.2	36.1	36.3
Expenditure on goods and services	21.9	20.7	20.7	20.7	21.1	22.0	21.9
Wages and salaries	7.6	7.0	7.1	7.9	7.6	7.6	7.6
Other goods and services	14.3	13.7	13.6	12.7	13.4	14.3	14.2
Current transfers and subsidies	11.4	11.0	11.1	11.4	12.9	14.0	14.3
Subsidies	0.7	0.8	1.0	1.1	1.4	1.6	1.5
Transfers to households	10.6	10.2	10.1	10.3	10.8	11.2	11.7
of which: Pensions	6.9	6.3	6.2	6.5	6.5	6.8	7.4
Family benefits	1.4	1.3	1.2	1.1	1.5	1.5	1.5
Sickness benefits	0.8	0.7	0.7	0.7	0.8	0.8	0.8
Unemployment benefits	0.1	0.1	0.1	0.2	0.2	0.2	0.2
Income maintenance	0.3	0.3	0.3	0.3	0.2	0.2	0.2
Disability benefits	0.1	0.4	0.5	0.5	0.5	0.5	0.5
Prescription drug benefits	0.5	0.6	0.7	0.6	0.6	0.6	0.6
Other	0.5	0.4	0.5	0.5	0.6	0.6	0.6
Transfers to the EU budget	...	...	...	...	0.7	1.2	1.0
Interest payments	0.3	0.2	0.2	0.3	0.2	0.2	0.2
Capital expenditure	2.9	3.0	3.6	2.8	2.9	3.4	2.8
Financial surplus (+) / deficit (-)	-1.0	0.3	1.3	2.9	1.7	0.4	0.0
Net lending	-0.4	-0.1	-0.1	0.0	0.0	0.0	0.0
Overall surplus (+) / deficit (-)	-0.6	0.4	1.4	2.9	1.7	0.4	0.0
Memorandum items:							
Primary fiscal balance (+, surplus)	-0.3	0.6	1.3	3.2	1.9	0.6	0.2
Total general government debt							
Excluding government assets held abroad	4.6	4.2	4.8	5.3	4.1	...	...
Including government assets held abroad	2.8	0.8	-0.6	-1.6	-2.4	...	...
Nominal GDP	92,938	104,459	116,915	127,334	141,493	159,570	175,671

Sources: Data provided by the Estonian authorities, and Fund staff estimates and projections.

Table 5. Estonia: Selected Financial Indicators, 2000–05

	2000	2001	2002	2003	2004	2005 May	2005 June	2005 July
	(In percent of total deposits)							
Banking sector reserves	23.2	13.6	11.2	13.5	16.2	15.6	15.0	15.9
Cash	3.7	3.1	2.7	2.6	2.2	1.7	1.8	1.6
Required reserves	15.9	16.3	16.7	20.5	26.6	26.1	26.4	25.8
Reserves held at the BoE 1/	19.6	10.5	8.6	11.0	14.0	13.8	13.2	14.2
Average risk-weighted capital adequacy ratio	13.2	14.4	15.3	14.5	13.4	12.4	10.9	12.2
Non-performing loans (in percent of total loans) 2/	1.0	1.3	0.8	0.4	0.3	0.3	0.2	0.2
Leverage ratio 3/	6.6	6.6	7.3	8.1	9.8	10.3	10.1	10.3

Sources: Bank of Estonia; and Fund staff estimates.

1/ Banks must meet reserve requirements on the basis of average reserve holdings over each reporting period. End of period levels can, therefore, be below the level of required reserves. Starting in January 2001, 3 percentage points of the 13 percent reserve requirement could be met with high quality euro-denominated foreign instruments. In July 2001, this foreign share of reserve requirements was raised to 50 percent.

2/ Non-performing loans are defined as loans overdue from 30-150 days and under current regulations all non-performing loans over 150 days are written off.

3/ Defined as the ratio of total liabilities to total capital; a decline in the ratio indicates improvement.

Table 6. Estonia: Indicators of External Vulnerability, 2000–05
(In percent of GDP, unless otherwise indicated)

(In percent of GDP, unless otherwise indicated)

	2000	2001	2002	2003	2004	2005	
						Projection	Date Actual data
Financial indicators							
Public sector debt 1/	4.7	4.4	5.3	5.3	4.1	3.8	
Broad money (percent change, 12-month basis)	29.7	23.0	11.2	10.9	15.8	30.2	7/31/2005
M1 (percentage change, 12-month basis)	20.1	19.5	9.3	13.0	17.4	25.6	7/31/2005
Private sector credit (percent change, 12 month basis)	30.3	22.2	27.8	27.0	31.2	34.3	7/31/2005
External Indicators							
Exports (percent change, annual average, in EURO)	52.3	4.1	-0.6	9.0	18.0	21.5	
Imports (percent change, annual average, in EURO)	41.5	4.3	5.4	11.5	17.4	15.8	
Current account balance	-5.5	-5.6	-10.2	-12.1	-12.7	-11.1	
Capital and financial account balance	7.8	4.7	10.9	14.3	14.3	15.9	
of which: Inward portfolio investment (debt securities etc.)	1.4	1.4	4.8	6.1	10.1	9.3	
Other investment (loans, trade credits etc.)	0.0	-0.4	6.4	3.5	5.0	8.7	
Inward foreign direct investment	7.1	9.0	4.1	10.1	10.1	9.3	
in the form of debt or loans	1.4	2.7	1.2	1.9	2.9	1.8	
Gross official reserves (in EURO millions)	992	930	958	1,098	1,098	1,317	
NFA of the consolidated banking system (in EURO millions)	599	785	496	-68	-730	-762	7/31/2005
Central Bank short-term foreign liabilities (in EURO millions)	3.3	1.0	6.4	30.7	32.2	33.6	7/31/2005
Short term foreign assets of the financial sector (in EURO millions) 2/	264	630	935	1,561	1,671	1779.1	
Short term foreign liabilities of the financial sector (in EURO millions)	868	979	1,399	1,733	2,039	2193.7	
Foreign currency exposure of the financial sector (in EURO millions)	510	1,063	959	2,007	2,173	2,770	7/31/2005
Official reserves in months of imports (excluding imports of goods for processing)	3.9	3.2	2.9	2.9	2.7	2.5	
Broad money to reserves	2.5	2.8	3.0	3.0	3.0	2.9	
Total short term external debt to reserves 3/	1.2	1.4	1.6	1.6	1.9	1.6	
Total external debt 4/ 5/	54.4	55.5	60.1	68.7	81.2	84.6	
of which: Public sector debt 1/	3.5	2.9	2.9	2.9	2.7	2.4	
Net external debt 6/	10.9	10.2	17.3	21.3	26.1	30.5	
Debt service to exports of GNFS (in percent)	6.8	8.0	9.7	11.1	12.5	12.5	
External interest payments to exports of GNFS (in percent)	1.8	1.8	1.7	1.5	1.5	1.9	
External amortization payments to exports of GNFS (in percent)	5.0	6.2	8.1	9.6	11.0	10.6	
Exchange rate (per US$, period average)	17.0	17.5	16.6	13.9	12.9	12.7	8/31/2005
REER, eop, appreciation (+)	-3.8	1.2	3.4	1.9	2.5	-1.9	6/30/2005
Financial Market Indicators							
Stock market index 7/	138.2	144.7	212.5	285.7	448.8	606.3	7/31/2005
Foreign currency debt rating 8/	BBB+	A-	A-	A-	A-	A-	7/31/2005
Spread of benchmark bonds (basis points, end of period) 9/	35.6	4.4	18.2	20.0	6.2	-1.4	9/28/2005

Sources: Country authorities, Bloomberg, Standard & Poor's, and Fund staff estimates.

1/ Total general government and government guaranteed debt excluding government assets held abroad.
2/ Excluding reserve assets of the Bank of Estonia.
3/ At remaining maturity.
4/ Starting in 2000, the definition of external debt was widened to include money market instruments and financial derivatives.
5/ Based on a wider definition of gross external debt than previously reported. Were it not for the change in definition of external debt, the gross debt to GDP ratio would have declined in 2000.
6/ Net of portfolio assets (including money market instruments), financial derivative assets, other investment assets, and reserve assets held by Estonian residents.
7/ Tallinn stock exchange index (TALSE), end of period.
8/ Standard & Poor's long-term foreign exchange sovereign rating.
9/ One-month spread between Tallinn interbank borrowing rate (TALIBOR) and the corresponding EURIBOR rate.

Table 7. Estonia: External Debt Sustainability Framework, 2000–10
(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2000	2001	2002	2003	2004			2005	2006	2007	2008	2009	2010	
										I. Baseline Projections				**Debt-stabilizing non-interest current account 6/**
External debt	54.4	55.5	60.1	68.7	81.2			**84.6**	**87.8**	**89.3**	**88.8**	**86.7**	**84.5**	**-7.3**
Change in external debt	-0.4	1.1	4.6	8.6	12.4			3.4	3.2	1.5	-0.5	-2.1	-2.2	
Identified external debt-creating flows (4+8+9)	-6.6	-6.8	1.2	-1.6	-0.6			1.0	1.7	1.2	0.6	0.2	0.0	
Current account deficit, excluding interest payments	3.8	4.1	8.8	10.9	11.4			9.4	8.6	7.6	6.5	5.8	5.2	
Deficit in balance of goods and services	3.8	3.5	7.1	7.6	7.8			6.9	6.4	5.8	5.2	5.0	4.9	
Exports	88.1	83.8	74.1	74.2	78.2			81.3	81.8	81.9	82.0	81.8	81.4	
Imports	91.9	87.3	81.2	81.8	86.0			88.2	88.2	87.6	87.2	86.8	86.4	
Net non-debt creating capital inflows (negative)	-5.5	-6.4	-3.0	-8.8	-6.4			-4.4	-3.6	-3.1	-2.8	-2.5	-2.3	
Automatic debt dynamics 1/	-4.9	-4.4	-4.6	-3.7	-5.6			-4.0	-3.3	-3.2	-3.1	-3.1	-2.9	
Contribution from nominal interest rate	1.6	1.6	1.3	1.2	1.3			1.7	1.8	1.9	2.0	2.0	2.0	
Contribution from real GDP growth	-3.8	-3.1	-3.6	-3.7	-4.8			-5.7	-5.0	-5.1	-5.1	-5.1	-4.9	
Contribution from price and exchange rate changes 2/	-2.8	-2.9	-2.3	-1.2	-2.0			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	6.2	7.9	3.3	10.3	13.0			2.5	1.4	0.3	-1.1	-2.3	-2.2	
External debt-to-exports ratio (in percent)	61.8	66.3	81.1	92.7	103.8			104.1	107.3	109.1	108.2	106.0	103.8	
Gross external financing need (in billions of Euros) 4/	1.6	1.9	2.5	3.1	3.7			4.0	4.3	4.6	4.9	5.2	5.6	
in percent of GDP	26.6	28.5	33.2	38.2	41.1			39.2	38.6	37.8	36.6	35.5	35.3	
Key Macroeconomic Assumptions						10-Year Historical Average	10-Year Standard Deviation							Projected Average
Real GDP growth (in percent)	7.9	6.5	7.2	6.7	7.8	6.4	2.8	7.9	6.5	6.3	6.2	6.2	6.2	6.6
GDP deflator in Euros (change in percent)	5.4	5.6	4.4	2.1	3.1	9.6	9.4	4.5	3.3	2.5	2.5	2.5	2.5	3.0
Nominal external interest rate (in percent)	3.4	3.2	2.7	2.2	2.1	3.2	0.8	2.3	2.3	2.3	2.4	2.4	2.5	2.4
Growth of exports (Euros, in percent)	38.8	7.0	-1.1	9.0	17.2	18.1	15.2	17.2	10.7	9.1	9.1	8.5	8.4	10.5
Growth of imports (Euros, in percent)	36.2	6.7	4.1	9.7	16.9	17.6	14.5	15.6	10.1	8.3	8.3	8.3	8.3	9.8
Current account balance, excluding interest payments	-3.8	-4.1	-8.8	-10.9	-11.4	-7.0	3.3	-9.4	-8.6	-7.6	-6.5	-5.8	-5.2	-7.2
Net non-debt creating capital inflows	5.5	6.4	3.0	8.8	6.4	6.5	2.5	4.4	3.6	3.1	2.8	2.5	2.3	3.1
										II. Stress Tests for External Debt Ratio				**Debt-stabilizing non-interest current account 6/**
A. Alternative Scenarios														
A1. Key variables are at their historical averages in 2006-10 5/								**84.6**	**79.3**	**72.8**	**65.8**	**58.7**	**52.4**	**-12.5**
B. Bound Tests														
B1. Nominal interest rate is at historical average plus two standard deviations in 2006 and 2007								**84.6**	**89.7**	**93.3**	**92.5**	**90.2**	**87.8**	**-7.4**
B2. Real GDP growth is at historical average minus two standard deviations in 2006 and 2007								**84.6**	**92.3**	**98.1**	**96.9**	**94.0**	**91.1**	**-7.9**
B3. Change in Euro GDP deflator is at historical average minus two standard deviations in 2006 and 2007								**84.6**	**98.7**	**111.3**	**109.0**	**105.0**	**101.1**	**-8.9**
B4. Non-interest current account is at historical average minus two standard deviations in 2006 and 2007								**84.6**	**92.7**	**99.9**	**98.7**	**96.1**	**93.3**	**-7.8**
B5. Combination of B1-B4 using one standard deviation shocks								**84.6**	**95.6**	**105.2**	**104.3**	**101.7**	**98.9**	**-8.4**
B6. One time 30 percent nominal depreciation in 2006								**84.6**	**121.7**	**120.9**	**117.7**	**112.8**	**108.1**	**-9.6**

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).
3/ For projection, line includes the impact of price and exchange rate changes.
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Table 8. Vulnerability Indicators for Emerging Market Economies, 2004

	Exchange Rate Regime	Saving	Investment	Current Account Balance	External Debt: Gross	External Debt: Net	of which Nonresident Deposits	Official Reserve Coverage of: Imports (in months)	Gross external financing requirement 1/	Short-term debt at remaining maturity	Short-term debt at remaining maturity and foreign currency deposits
		(In percent of GDP)							(In percent)		
Baltics											
Estonia	Currency board in ERM II	21	31	-12.7	81	26	-	2.5	73	61	40
Latvia	Euro peg ±1 percent band in ERM II	19	30	-12.3	85	26	41	3.3	36	29	23
Lithuania	Currency board in ERM II	15	21	-9.5	43	29	9	3.5	41	48	32
Central European Countries											
Czech Republic	Managed float	23	27	-5.1	36	-	-	4.6	74	159	110
Hungary	Euro peg with ±15% band	17	23	-9.1	63	-	-	2.8	77	176	-
Poland	Independent float	18	19	-1.6	49	-	-	4.6	99	170	107
Slovak Republic	Managed float	24	26	-3.1	45	-	-	5.5	95	120	110
Slovenia	Euro peg with ±15% band	26	27	-0.9	59.4	7.7	5.1	5.0	293	122	119
Other Emerging Markets											
Chile	Independent float	23	20	2.5	47	-	-	6.5	74	113	82
Malaysia	Dollar peg	35	20	13.4	43	-	-	6.8	-5557 2/	462	443
Mexico	Independent float	20	21	-1.1	25	-	-	5.2	143	157	129
Thailand	Managed float	31	25	4.4	30	-	-	5.6	72	234	214

Source: WEO, IFS, and staff estimates.

1/ Current account deficit plus amortization of external debt.
2/ The large negative value reflects Malaysia's negative gross external financing requirement (owing to a large current account surplus) and very high level of reserves.
3/ Official and commercial banks' gross reserves.

Table 9. Estonia: Macroeconomic Framework—Baseline and Alternative Scenarios
(In percent of GDP, unless otherwise indicated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
						Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Baseline scenario											
Domestic saving	22.3	23.5	21.6	19.9	18.5	20.1	20.6	21.5	22.4	23.1	23.8
Private	20.0	20.1	16.9	14.2	13.9	16.3	17.9	18.2	19.1	19.8	20.5
Public	2.3	3.4	4.7	5.7	4.6	3.7	2.8	3.3	3.3	3.3	3.3
Investment	27.8	29.2	31.8	32.0	31.2	31.2	31.0	30.9	30.9	30.9	31.0
Private	24.8	26.1	28.2	29.2	28.3	27.8	28.2	27.6	27.6	27.6	27.7
Public	2.9	3.0	3.6	2.8	2.9	3.4	2.8	3.3	3.3	3.3	3.3
Foreign saving	5.5	5.6	10.2	12.1	12.7	11.1	10.4	9.4	8.4	7.8	7.2
Memorandum items:											
GDP real growth (year-on-year in percent)	7.9	6.5	7.2	6.7	7.8	7.9	6.5	6.3	6.2	6.2	6.2
Total gross external debt, in percent of GDP	54.4	55.5	60.1	68.7	81.2	84.6	87.8	89.3	88.8	86.7	84.5
Alternative scenario											
Domestic saving	22.3	23.5	21.6	19.9	18.5	20.1	20.4	20.4	20.7	20.9	21.3
Private	20.0	20.1	16.9	14.2	13.9	16.3	17.5	17.1	17.4	17.6	18.0
Public	2.3	3.4	4.7	5.7	4.6	3.7	2.8	3.3	3.3	3.3	3.3
Investment	27.8	29.2	31.8	32.0	31.2	31.2	31.1	31.0	30.9	30.9	31.1
Private	24.8	26.1	28.2	29.2	28.3	27.8	28.2	27.6	27.6	27.6	27.8
Public	2.9	3.0	3.6	2.8	2.9	3.4	2.8	3.3	3.3	3.3	3.3
Foreign saving	5.5	5.6	10.2	12.1	12.7	11.1	10.7	10.5	10.2	10.0	9.8
Memorandum items:											
GDP real growth (year-on-year in percent)	7.9	6.5	7.2	6.7	7.8	7.9	6.5	6.3	6.2	6.2	6.2
Total gross external debt, in percent of GDP	54.4	55.5	60.1	68.7	81.2	84.6	88.3	91.2	92.5	92.2	91.9

Sources: Estonian authorities, and Fund staff estimates.

Estonia: Fund Relations
(As of August 31, 2005)

Membership Status: Joined May 26, 1992; Article VIII.

General Resources Account:	**SDR Million**	**Percent of Quota**
Quota	65.20	100.0
Fund holdings of currency	65.20	99.9
Reserve position in Fund	0.01	0.01

SDR Department:	**SDR Million**	**Percent of Allocation**
Holdings	0.05	N.A.

Outstanding Purchases and Loans: None

Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR million)	Amount Drawn (SDR million)
Stand-by	3/1/00	8/31/01	29.34	0.00
Stand-by	12/17/97	3/16/99	16.10	0.00
Stand-by	7/29/96	8/28/97	13.95	0.00

Projected Obligations to Fund (SDR million; based on existing use of resources and present holdings of SDRs): None

Implementation of HIPC Initiative: Not applicable

Safeguards Assessment:

Under the Fund's safeguards assessment policy, the Bank of Estonia was subject to the transitional procedures with respect to the Stand By Arrangement which was approved on March 1, 2000 and which expired on August 31, 2001. The transitional procedures require a review of only the BOE's external audit mechanism. This assessment determines whether the BOE publishes annual financial statements that are independently audited in accordance with internationally accepted standards. The external audit assessment was completed on December 13, 2000. The assessment concluded that BOE's external audit mechanism is adequate, as reported in 2001 Article IV Staff Report.

Exchange Arrangements:

The currency of Estonia is the kroon. The kroon replaced the ruble on June 20, 1992. Since that date, the Bank of Estonia has guaranteed the conversion of kroon bank notes, coins, and reserve deposits of commercial banks at a fixed rate of exchange of EEK 15.6466 per euro (and EEK 8 per deutsche mark until 31 December, 2001). Estonia has accepted the

obligations of Article VIII, Sections 2, 3, and 4. Estonia maintains an exchange system that is free of restrictions on payments and transfers for current international transactions, apart from restrictions in accordance with the United Nations Security Council Resolutions 1076, 1269, 1333, 1368 and 1373 and the measures adopted by the EU within the framework of the Common Foreign and Security Policy. All such restrictions have been notified to the Fund according to Decision 144-(52/51). It appears that Estonia does not maintain restrictions on capital transactions.

Article IV Consultation:

The 2004 Article IV consultation was concluded by the Executive Board on November 8, 2004.

FSAP Participation and ROSCs:

A joint World Bank-International Monetary Fund mission conducted an assessment of Estonia's financial sector as part of the Financial Sector Assessment Program (FSAP) in March, 2000. The associated Reports on Observance of Standards and Codes (ROSC), and the Financial Sector Stability Assessment (FSSA) report, were completed in June and August 2000 respectively. IMF missions also conducted assessments of fiscal transparency, and data quality and dissemination practices, in Estonia, in April and May 2001, respectively. These assessments were discussed in the 2001 Article IV consultations, and the resulting ROSC modules were completed later that year. The ROSC modules were updated during the 2002 Article IV consultation. The updates were published on the Fund's external website.

ROSC MODULES

Standard/Code assessed	**Issue date**	**Updated**
Banking Supervision	June 30, 2000	July 3, 2002
Insurance Supervision	June 30, 2000	July 3, 2002
Monetary and Financial Policy Transparency	June 30, 2000	July 3, 2002
Payments Systems	June 30, 2000	July 3, 2002
Securities Regulation	June 30, 2000	July 3, 2002
Fiscal Transparency	July 9, 2001	July 3, 2002
Data Quality and Dissemination	October 19, 2001	July 3, 2002

Technical Assistance:

TECHNICAL ASSISTANCE FROM THE FUND, 2000–05

DEPT	Project	Action	Timing	Counterpart
FAD	Pension Reform	Mission	April 2000	Ministries of Finance and Social Affairs
MAE	Banking Supervision	Staff Visit	December 2000	Bank of Estonia
FAD	Tax Policy	Mission	March 2001	Ministry of Finance

TECHNICAL ASSISTANCE FROM THE FUND, 2000–05

DEPT	Project	Action	Timing	Counterpart
INS	Financial Markets	Training	September 2002	Bank of Estonia
FAD	Medium-term Budget	Technical Assistance	December 2003	Ministry of Finance
FAD	Tax Reform	Technical Assistance	February 2005	Ministry of Finance

Resident Representative:

Mr. Adalbert Knöbl was senior resident representative in Estonia and Latvia until 2002. His position was not replaced and since then till its closure in December 2004 the office in Estonia was run by two local staff.

Fourth Amendment:

Estonia accepted the Fourth Amendment of the Articles of Agreement in April 1999.

ESTONIA: STATISTICAL ISSUES

1. Estonia is a subscriber to the Special Data Dissemination Standard (SDDS). The Bank of Estonia (BoE) publishes a wide variety of data on the key variables for each of the four sectors—monetary, fiscal, real and external—on its website, with periodic updates. Economic and financial data provided to the Fund is adequate for surveillance.

2. The following is a summary of both the frequency and the timing of key data as made available to Fund staff:

A. Monetary Statistics

3. Monetary data are published by the Bank of Estonia (BoE).[1]

- Monthly reporting of BoE balance sheet (base money and NIR) is available on the eighth day following the end of the month.[2]
- Monthly broad money and its components are available from the BoE on the thirteenth banking day from the beginning of the month.[2]
- Monthly interest rate updates on domestic and foreign currency transactions are available on the seventeenth banking day from the beginning of the month.[2]

B. Financial Statistics

4. All financial data are compiled by the Bank of Estonia (BoE) and are reported on a monthly basis:[3]

- Commercial bank reserves data are available on the eleventh banking day from the beginning of the month.[2]
- Commercial bank off-balance sheet data are available on the eighteenth banking day from the beginning of the month. [2]

[1] All monetary data are collected with a frequency of 10 days and are available to Fund staff upon request.

[2] Indicates publicly available data on the Bank of Estonia website (http://www.bankofestonia.info/frontpage/en).

[3] Data for individual banks are also available on a quarterly basis.

- Average capital adequacy ratios are available on the thirteenth banking day from the beginning of the month.[2]

- Nonperforming loans data are available on the seventeenth banking day from the beginning of the month.[2]

- Leverage ratios are available on the eighteenth banking day from the beginning of the month.

- Liquidity ratios are available on the eighteenth banking day from the beginning of the month.

- NFAs of commercial banks are available on the eleventh banking day from the beginning of the month.[2]

- Net open foreign exchange positions are available on the eleventh banking day from the beginning of the month.

- Short-term external debt are available on the eighteenth banking day from the beginning of the month.

C. Balance of Payments Statistics

5. All balance of payments data are also compiled by the Bank of Estonia (BoE):

- Daily exchange rate data are available with a one-working day lag.[2]

- Monthly imports/exports data are available with a two-month lag.

- Quarterly current account data are available with a one-quarter lag (Monthly flash estimates are also published.).[2]

- Quarterly international investment position data, including public and private external debt data are available with a one-quarter lag.[2]

D. Government Finance Statistics

6. All fiscal data are published by the Ministry of Finance (MoF).

- Monthly central government operations data are available with a lag of up to 25 days after the end of the month. The government has started to report monthly data on a consolidated government basis in January 1999 (http://www.fin.ee/?lang=en).

- Quarterly data on foreign loans and guarantees by the central government are available with a one-month lag.

- Comprehensive annual cash data on central government and local government operations to 2001 are reported in the *GFS Yearbook 2004*. Balance sheet data is incomplete with only liabilities, domestic and foreign reported. Only annual data to 2001 are reported in the *International Finance Statistics.* Annual general government operations data (cumulative) for 2002 are available on Estonia's National Summary Data Page (NSDP).

E. National Accounts Statistics

- Data on GDP (quarterly, by semester, and annually) are currently being issued by the Statistical Office of Estonia (SOE) with a lag of four months after the end of the quarter. Flash estimates of aggregate GDP are available two months after the end of the quarter.[4]

- Monthly CPI inflation data are available seven days after the end of the accounting period, and are received directly from the SOE. Monthly PPI and Export Price Index data are available four weeks after the end of the accounting period.[4]

- Monthly indicators of output, i.e., retail trade, industrial output, industrial sales, are reported approximately six weeks to two months after the end of the accounting period.[4]

Monthly wage data (nominal) are produced by the SOE with a two-month lag. Quarterly wage data (nominal and real) are now produced by the SOE with a lag of two months.[4]

[4] Indicates publicly available data on the Statistical Office of Estonia website (http://www.stat.ee).

Estonia: Table of Common Indicators Required for Surveillance
(As of August 31, 2005)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]	Memo Items:	
						Data Quality – Methodological soundness[7]	Data Quality – Accuracy and reliability[8]
Exchange Rates	8/31/05	8/31/05	M	M	M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]							
Reserve/Base Money	8/31/05	9/9/05	M	M	M	O, LO, LO, LO	O, O, O, NA
Broad Money	8/31/05	9/21/05	M	M	M		
Central Bank Balance Sheet	8/31/05	9/9/05	M	M	M		
Consolidated Balance Sheet of the Banking System	8/31/05	9/21/05	M	M	M		
Interest Rates[2]	August 05	9/21/05	M	M	M		
Consumer Price Index	August /05	9/9/05	M	M	M	O, O, O, O	LO, LO, O, LO
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]						LO, LO, O, O	LO, LO, O, NO
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government							
Stocks of Central Government and Central Government-Guaranteed Debt[5]							
External Current Account Balance	Q4 2004	3/31/05	Q	Q	Q	O, O, LO, O	O, O, O, O
Exports and Imports of Goods and Services							
GDP/GNP	Q2 2005	9/28/05	Q	Q	Q	O, O, O, LO	LO, LO, LO, LNO
Gross External Debt	Q4 2004	3/31/05	Q	Q	Q		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).
[7] Reflects the assessment provided in the data ROSC published on November 6, 2001 and based on the findings of the mission that took place during May 10-18, 2001 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).
[8] Same as footnote 7, except referring to international standards concerning (respectively) source data, statistical techniques and revision studi

Statement by David Farelius, Alternate Executive Director for Republic of Estonia and Timo Kosenko, Advisor to Executive Director
October 26, 2005

Our Estonian authorities would like to express their appreciation to Mr. Haas and his team for the constructive discussions and the set of high quality papers. The authorities broadly agree with staff's assessment as well as with the recommendations for the years ahead.

Recent economic developments and prospects

Estonia is enjoying the sixth consecutive year of rapid economic expansion, underpinned by strong macroeconomic fundamentals, the EU entry and appropriately flexible market structures. In the current cyclical position, the real GDP growth reached 8.5 percent in the first half of 2005 and is expected to exceed 8 percent for 2005 as a whole. Thereafter the output expansion is expected to move closer to the long-term average that is revised upwards to 6 - 7 percent. While the domestic demand remains strong, the recent acceleration of growth is mostly accounted for by a buoyant export performance, contributing some additional 2 percentage points to the previous forecasts.

After the anticipated gradual decline during the first half of 2005, the rate of the annual CPI inflation picked up to 4.9 percent in September. The authorities have correspondingly changed their inflation forecast to 4.2 percent for 2005. This recent acceleration is mostly driven by the increase in oil prices. While the authorities remain vigilant to pre-empt possible second round effects, they are confident that the medium-term inflationary pressures remain modest. Moreover, as noted by staff in the Selected Issues paper, the impact of energy shocks on core inflation in Estonia has been low, likely reflecting the degrees of product market competition and labor market flexibility. Against this backdrop, the authorities expect the headline inflation to decline to somewhat above 3 percent in 2006, slightly lower than staff's projections, provided that oil prices will not reach new highs.

Long term confidence effects, rapid income growth and rising employment - in the context of full integration of Estonia's banking system with the European markets and favorable interest rate environment - have fuelled the private sector credit, particularly mortgage financing. By June 2005, the rate of credit expansion has leveled off at slightly above 40 percent year-on-year, with the accompanying rise in real estate prices remaining at the level of 20 percent. The authorities are well aware that vigilance is needed to avoid the possible undesirable effects of the rapid credit growth on the medium term developments. In this context, they take note of staff's suggestion to further reduce the tax deductibility of mortgage interest payments.

After peaking at 12.7 percent of GDP in 2004, mostly due to one-off shocks related to the EU accession and a number of large infrastructure investment projects, the current account deficit has remained on a declining trend with the four-quarter average decreasing to 10.4 percent of GDP in the first half of 2005. The deficit is expected to continue to decline gradually in the coming years, supported by the competitive export sector and gradually

increasing domestic savings. Strong profitability of foreign-owned enterprises is expected to continue to have an impact on the headline deficit. As has been the case in the recent years, the reinvested profits will likely account for about half of the current account deficit (4.7 percent of GDP in 2004).

Staff notes the declining share of the net FDI in capital inflows. A significant part of this is attributable to increased FDI by Estonian companies. Moreover, the full integration of Estonia's financial system with European markets has resulted in substituting part of intra-group transactions for borrowing from Estonian subsidiaries and branches of large regional banking groups. Nevertheless, the authorities are fully aware that vigilance and prudent macroeconomic stance is needed to support the continuing decrease of the current account deficit.

Adoption of the euro

While the EU accession has provided a new impetus to the development of the economy and the society, the authorities recognize that the adoption of the euro would enable Estonia to reap full benefits of economic integration and the single market. Therefore, the adoption of the euro by 2007, in full compliance with the well known provisions of the common EU framework, remains an overarching goal for the Estonian authorities. Moreover, they are well aware of the need to maintain prudent macroeconomic stance and to continue with advanced structural reforms to ensure sustainable economic development and real convergence after joining the Euro Area. The authorities share staff's emphasis on maintaining labor and product market flexibility as the key to sustainable convergence in both the near and medium-term.

Estonia is expected to have little difficulties in meeting most of the Maastricht criteria. Estonian kroon has maintained its peg to the euro, including in the ERM II framework, the general budget has been in surplus for the past five years and the long-term interest rate differential with the euro rates remains negligible. Moreover, the gross public debt is low at 5.5 percent of GDP and accumulated gross reserves of the public sector amount to over 10 percent of GDP. Practical preparations for the currency changeover are also well underway. Looking ahead, the recent surge in the headline inflation rate is the biggest challenge, as the relatively higher share of energy and liquid fuel in the Estonian consumer basket (adding up to over 20 percent) makes the CPI inflation sensitive to changes in the world market conditions. However, it is reassuring that the core inflation has remained stable at around 2 percent year-on-year.

Macroeconomic policies in 2005

The authorities remain committed to the transparent macroeconomic framework to support sustained economic expansion and smooth entry into the Euro Area. Their policies remain firmly centered around the currency board framework, underpinned by the general government's fiscal position being balanced or in surplus, the strong financial system and labor and product market flexibility. The authorities recognize that the current combination of high output growth and low interest rates leaves no room for complacency to maintain

stable and balanced economic development; the sustainability of the external position remains a key issue. While the underlying inflation rate is ultimately driven by external factors in a small and very open economy with the currency board arrangement, the authorities make every effort to ensure stability of the price level and to avoid excessive real exchange rate appreciation.

Fiscal policy

Fiscal policy has a key role for the economy functioning under a currency board arrangement. The authorities have a well established track record of fiscal prudence and the general government is running a surplus budget for the fifth consecutive year. At this stage, the official estimates put the general government surplus for 2005 to over 1 percent of GDP, mostly due to higher than expected output growth and continuous improvements in tax collection, while even higher outcome could not be ruled out. With traditionally conservative growth estimates, the government is planning a balanced budget from 2006 onwards.

The authorities' medium-term budgeting process relies on the State Budget Strategy; in addition, the annual budgeting process takes into account the medium-term impact of next year's budget decisions. The authorities share staff's view of the importance of medium-term budgeting in order to maintain fiscal prudence and to improve expenditure control.

Financial sector policies

The sixteen months of participation in the ERM II mechanism have been uneventful. The Estonian kroon has not experienced any pressures and the short-term interest rate differential against the euro has been negligible at 10-15 bps. Estonia will maintain its currency board arrangement as a unilateral commitment while in the ERM II.

The still rapid credit growth underlines the need to ensure the credibility of the financial system and to avoid possible unwarranted macroeconomic impact if the credit market conditions start to change. As the staff's report notes, the banking sector remains financially sound in every aspect, with profitability solid, the share of nonperforming loans negligible and consolidated capital adequacy ratio at 12 percent, comfortably above the legal minimum requirement of 10 percent. Both the Financial Supervisory Authority (FSA) and banks are performing periodic, forward-looking stress tests of the balance sheets, which have confirmed the soundness of the banking system.

The authorities are monitoring the situation very carefully and stand ready to implement necessary measures, should the credit standards show any signs of worsening. However, with Estonia's banks being fully integrated with Nordic financial groups in both financial and institutional terms and in the context of EU's single market for financial services, the authorities' very close cooperation with financial supervisors of the region is equally important. Maintaining prudent lending policies is also instrumental to contain the increasing gross indebtedness of Estonia's private sector even if Estonia's net position vis-à-vis the rest of the world is not yet alarmingly high.

Structural policies

Estonian business climate remains attractive by international standards with the World Bank's recent survey "Doing Business 2005" ranking Estonia as 16th by ease of doing business. It is, therefore, not surprising that Estonia continues to enjoy sizable gross FDI inflows that reached new highs at around 12 percent of GDP in the first half of 2005 (excluding a major investment in financial sector that amounted to over 20 percent of GDP). The productivity growth has increased further, reaching 6.8 percent in the first half of 2005. Recent developments on the labor market are encouraging with unemployment falling from the peak of 13.6 percent in 2000 to 9.7 percent in 2004 and 8.1 percent in the second quarter of 2005. The number of people unemployed for a year or longer has also fallen to the lowest level of the past six years. While the EU membership appears to have had a significant impact on labor market developments in certain sectors, most notably in the health care and construction, the Estonian authorities agree with staff's advice regarding the wage developments.

Estonia firmly supports the Lisbon goals of higher growth and employment. In October 2005, the Government approved the National Action Plan, focusing on measures to sustain macroeconomic stability and increase competitiveness, including higher investments into R&D, active labor market policies and measures to improve business climate and entrepreneurship.

The authorities continue their advanced reform agenda in the network industries where market liberalization in several sectors, including in the telecom sector, was already accomplished some years ago. In accordance with the EU directives and provisions governing Estonia's accession to the EU, the electricity market will be fully opened for competition by 2012. The market for natural gas is already liberalized to a large extent; the draft legislation is currently discussed in the Parliament to effectively increase the openness of the market for natural gas from 90 to 95 percent.

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 05/152
FOR IMMEDIATE RELEASE
November 4, 2005

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2005 Article IV Consultation with the Republic of Estonia

On October 26, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Estonia.[1]

Background

Estonia has made extraordinary progress following independence. Sound macroeconomic policies and far-reaching structural reforms have resulted in the successful establishment of a market economy and EU membership. The country is witnessing a remarkable convergence in real terms to EU levels, with purchasing power parity per capita income increasing to 46 percent of the EU15 level. Estonia has also achieved significant nominal convergence, meeting all of the Maastricht criteria, save for inflation. Estonia entered ERM II in late June 2004, unilaterally maintaining its peg to the euro with a currency board arrangement, and is aiming at early euro adoption.

Robust economic growth continues, largely driven by domestic demand. Real GDP growth increased to nearly 8 percent in 2004 (from 6¾ percent a year earlier) and accelerated further, to 8½ percent year-on-year, in the first half of 2005. Inflation has increased since mid-2004 and remains significantly above the Maastricht criterion. Headline inflation reached 4.9 percent year-on-year in September and, with current policies, is forecast to remain above the Maastricht criterion by the time of the earliest possible test date in mid-2006. At the same time labor market conditions have tightened: in the second quarter of 2005, the unemployment rate declined to 8.1 percent, overall employment continued to grow and wages increased by 11 percent. With output estimated to be close to potential and labor shortages appearing in the construction sector, signs of nascent overheating are emerging.

---

[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. This PIN summarizes the views of the Executive Board as expressed during the Executive Board discussion based on the staff report.

The current account deficit remains large, increasing external vulnerabilities. Despite strong export growth, the current account deficit widened to 12.7 percent of GDP in 2004. However, on the heels of a strong export performance, it subsequently declined to 10.4 percent of GDP in the first half of 2005.

Following four years of tight fiscal policy, the fiscal stance eased in 2004, and is projected to ease further in 2005. The fiscal surplus declined to 1.7 percent of GDP in 2004 when the government increased expenditures in a supplementary budget late in the year. As a result of higher pension expenditures planned for the second half of this year, and a recent supplementary budget allocating a good part of revenue overperformance to additional spending, the fiscal surplus will decline again in 2005 to a projected 0.4 percent of GDP. The 2006 budget foresees a further easing to an overall balanced position.

The rapid expansion of credit to the private sector continued in 2004 and the first half of 2005, financed increasingly by borrowing from abroad. Credit growth to households accelerated to above 50 percent in 2004, year-on-year, with household loans for real estate accounting for over 80 percent of this. Credit growth to enterprises reached 48 percent at end-June 2005 from around 25 percent a year earlier. Estonia's banking system remains financially sound, with strong profitability continuing despite increased competition. Confidence in the currency board remains strong.

Executive Board Assessment

The Executive Directors commended the authorities on the remarkable progress Estonia has made in the 14 years since independence, which has been made possible by sound macroeconomic policies and far-reaching structural reforms. These policies have achieved sustained growth and declining unemployment, and the country is rapidly converging to EU levels. Directors considered that the economic outlook is generally favorable, but noted the nascent signs of overheating, including the rapid growth in domestic credit, and the country's continuing external vulnerabilities. In these circumstances, Directors called for fiscal restraint and careful monitoring of credit developments in the short term, and continued efforts to maintain product market and wage flexibility for safeguarding competitiveness.

Many Directors viewed the continuing large current account imbalance with concern. The current account deficit has been at a level that is unsustainable over the longer-term and needs to be addressed. Directors noted that the deficit did not appear to stem from any problems of competitiveness, but has rather been influenced by macroeconomic conditions. They emphasized that, in the context of Estonia's currency board, fiscal restraint is needed to restrict domestic demand and reduce the external imbalances.

Directors commended the authorities for their pursuit of prudent fiscal policy over several years. At the same time, they noted that the decline in the fiscal surplus in 2005, and the further decline planned in 2006, meant that fiscal policy will continue to impart a positive fiscal impulse when the economy is showing signs of overheating and external imbalances are large. Furthermore, they noted that, in Estonia, fiscal policy is the only effective stabilization tool. In these circumstances, Directors considered that fiscal policy should be tightened. Should any windfall revenues occur, they should be saved and the expansionary effects of the recent supplementary budget should be reversed in 2006 to limit demand pressures. Directors welcomed the plans to introduce medium-term budgeting aimed at improving expenditure control. They agreed that the medium-term budget should target balanced budgets over the cycle enabling a gradual reduction in the fiscal surplus.

Directors noted that the banking sector remains sound, with strong bank balance sheets, good supervision, and well developed risk management systems. Nevertheless, they expressed concern about the high growth rate of credit, especially as much of the increase in domestic credit is funded by foreign borrowing and used to finance credit to the domestic real estate market. Directors agreed with the authorities that, in the absence of an independent monetary policy, large scale measures to restrict credit growth are largely precluded. Still, they urged the authorities to use all tools at their disposal to reduce the demand for credit, including by tightening prudential regulations should banks loosen their credit standards. Accordingly, Directors welcomed the authorities' intention to remain vigilant and stand ready to implement any needed measures. They also welcomed the authorities' progress on implementing Anti-Money Laundering/Combating Financing of Terrorism legislation in line with international norms.

Many Directors observed that, while inflation is relatively high, it is not seen as a threat to competitiveness as it is declining and core inflation is under control. Nevertheless, it will be challenging for Estonia to meet the Maastricht inflation criterion in 2006, although Estonia has otherwise achieved an impressive degree of convergence toward the euro area. Directors observed that the currency board remains credible, as indicated by Estonia's relatively high credit rating, and is a viable strategy in the run up to euro adoption.

Directors observed that flexible labor and product markets are critical in a country where there is no nominal exchange rate flexibility and, consequently, it is important for Estonia to maintain the high degree of market flexibility that has been achieved. They also noted the need to keep wage increases in line with productivity increases, if Estonia is to remain competitive. Directors were supportive of Estonia's recent steps to increase employment through active labor market policies. They also welcomed the planned reforms to increase competition in the electricity and telecommunications sectors.

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. The staff report for the Article IV consultation with the Republic of Estonia may be made available at a later stage if the authorities consent.

Republic of Estonia: Selected Economic Indicators

	1999	2000	2001	2002	2003	2004
Real Economy						In units as indicated
Real GDP growth, in percent	0.3	7.9	6.5	7.2	6.7	7.8
Average CPI inflation, in percent	3.3	4.0	5.8	3.6	1.3	3.0
Unemployment rate (ILO definition), in percent	12.2	13.7	12.6	10.3	10.0	0.7
Domestic saving, in percent of GDP	20.5	22.3	23.5	21.6	19.9	18.5
Domestic investment, in percent of GDP	24.9	27.8	29.2	31.8	32.0	31.2
Public Finance						In percent of GDP
General government balance	-4.3	-0.6	0.4	1.4	2.9	1.7
General government external debt						
Excluding government assets held abroad	4.9	3.5	2.9	2.9	2.9	2.7
Including government assets held abroad	1.9	1.6	-0.6	-2.6	-5.5	-5.4
Money and Credit						Changes in percent
Base money	27.1	14.6	-9.8	-1.5	14.6	24.0
M1	32.1	20.4	19.5	9.3	13.0	17.4
Broad money	23.7	25.7	23.0	11.2	10.9	15.8
Domestic credit to nongovernment	6.3	30.3	22.2	27.8	27.0	31.2
Balance of Payments						In percent of GDP
Goods and non-factor services balance	-4.6	-3.8	-3.5	-7.1	-7.6	-7.8
Current account	-4.4	-5.5	-5.6	-10.2	-12.1	-12.7
Gross international reserves (euro, millions)	852	992	930	958	1098	1317
Exchange Rate						
Exchange rate regime	Currency Board Arrangement					
Exchange rate parity	EEK15.6466=€1					
Real effective exchange rate, end of period, 2000=100 1/	101.9	100.0	101.6	104.9	108.3	

Sources: Estonian authorities, and IMF staff estimates.
1/From INS, export-share weighted CPI real exchange rate against 15 major trading partners.