

Republic of Estonia: 2008 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the 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 2008 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 2008 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on December 15, 2008, 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 February 17, 2009. 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 staff statement of March 2, 2009, updating information on recent developments.
- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its March 2, 2009 discussion of the staff report that concluded the Article IV consultation.
- A statement by the Executive Director for the Republic of Estonia.

The documents listed below will be separately released.

Selected Issues Paper
Financial System Stability Assessment

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

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INTERNATIONAL MONETARY FUND

REPUBLIC OF ESTONIA

Staff Report for the 2008 Article IV Consultation

Prepared by the Staff Representatives for the 2008 Consultation with the Republic of Estonia

Approved by Anne-Marie Gulde and Philip Gerson

February 17, 2009

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EXECUTIVE SUMMARY

Background: The financial sector and the currency board arrangement weathered the 2008 global turmoil well but an already severe recession will be deepened by the global crisis. The demand decline has shrunk the external current account deficit, ended the credit boom and cooled the property market. But the recession is presenting a stiff challenge to labor market flexibility, fiscal management and banks' profitability. Moreover wage growth has been outpacing productivity, undermining profits and competitiveness.

Outlook: Weak domestic and global demand will lead to a severe contraction in 2009 and—assuming a global recovery—a slow recovery in 2010. The severity of the contraction and the timing of the recovery are uncertain because of the unsettled external environment and lags in the wage response.

External stability: The real exchange rate is somewhat overvalued but external imbalances have shrunk. External risks are being mitigated by the slower growth of foreign-funded credit and a strengthened framework to contain liquidity risk.

Policy advice: Policy discussions focused on the fiscal stance, financial sector resilience and labor market flexibility. On fiscal policy, large expenditure increases over the past two years are unsustainable and leave little room for countercyclical measures which would anyway be of only modest impact. More important is to limit the run-down of the government's liquidity buffers in order to maintain support for the currency board, adhere to the Maastricht deficit ceiling and move gradually to a structural surplus that would support the overarching target of "balance or better" through the business cycle. The mission supported plans to freeze the government wage bill for 2009-10, nudging the economy towards wage restraint. On the financial sector, staff agreed that a key objective should be euro adoption, to reduce vulnerability to financial turbulence. The mission welcomed the authorities' decision to implement the main recommendations of the FSAP-update mission, notably to strengthen crisis management frameworks. Staff supported government's efforts to increase labor market flexibility while improving social safety nets.

Authorities' position: The authorities were confident that the economy's flexibility would facilitate a recovery. They reaffirmed their commitment to euro adoption and to fiscal balance or surpluses over the medium term.

Mission: Discussions were held in May and December 2008. The team comprised Franek Rozwadowski (Head), Nada Choueiri, Anastassios Gagales, Mark Lutz (all EUR), Pedro Rodriguez (SPR), and Steven Seelig (MCM).

I. INTRODUCTION

1. **Estonia is facing its most severe recession since the early 1990's.** The downturn started as the reversal, in early 2007, of a credit-driven domestic boom and gained momentum from the global financial crisis and a collapse in domestic confidence. The recession is reducing domestic and external imbalances but its pace and depth have created large budget deficits and are putting pressure on private sector balance sheets. The consultation focused on the macroeconomic outlook, domestic and external financial sector vulnerabilities, and policy options for the difficult times ahead.

Box 1. Implementation of Fund Policy Advice

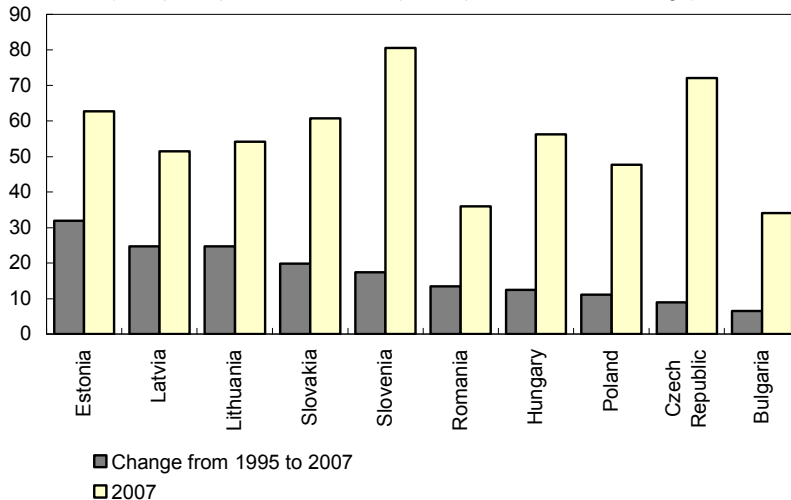
Relations between Estonia and the Fund have been excellent. While policy implementation has been characterized by a high degree of ownership, which has been key to Estonia's economic success, the authorities report that their decisions have benefited considerably from Fund advice. Indeed, their policies have generally been consistent with such advice. A case in point is the adoption of the key recommendations of the 2008 FSAP update. However, in 2007-2008, large increases in expenditure, counter to Fund advice, resulted in structural fiscal policy loosening.

II. BACKGROUND

2. **An outstanding economic performance gave way in 2005-07 to a credit-led boom and widening external imbalances.** Far-reaching structural reforms and macroeconomic stability supported an

impressive convergence in per capita GDP (Figure 1). Macroeconomic imbalances were manageable at first, but burgeoning confidence, related to EU accession, and access to abundant liquidity from abroad fueled demand in 2005-06, particularly in the real estate sector. As in other Baltic countries, GDP growth rose well above potential, inflation accelerated, and the current account deficit widened alarmingly (Figures 2-3, Tables 1-6). Asset prices rose sharply, driven in part by self-fulfilling expectations, and adding fuel to demand.

Figure 1. Income Convergence in New Member States, 1995 and 2007 1/
(PPS per capita GDP at current prices, percent of EU15 average)

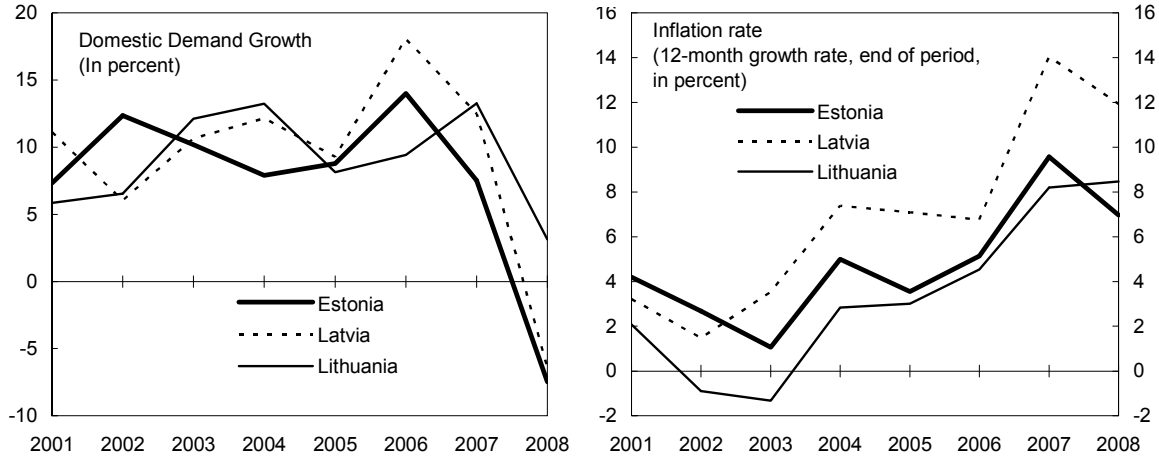


Source: Eurostat.

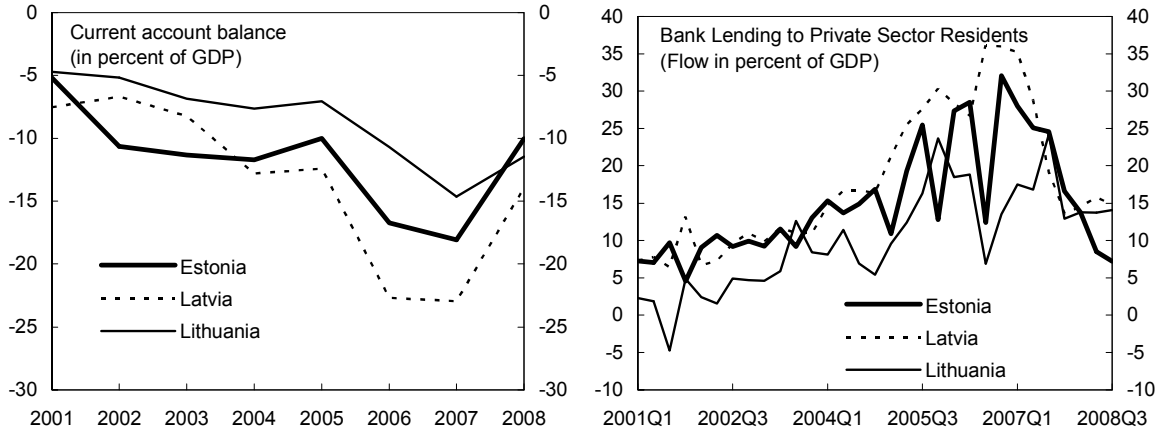
1/ Except for Romania where data is for 1999.

Figure 2. The Baltics: Recent Developments, 2000-08 1/

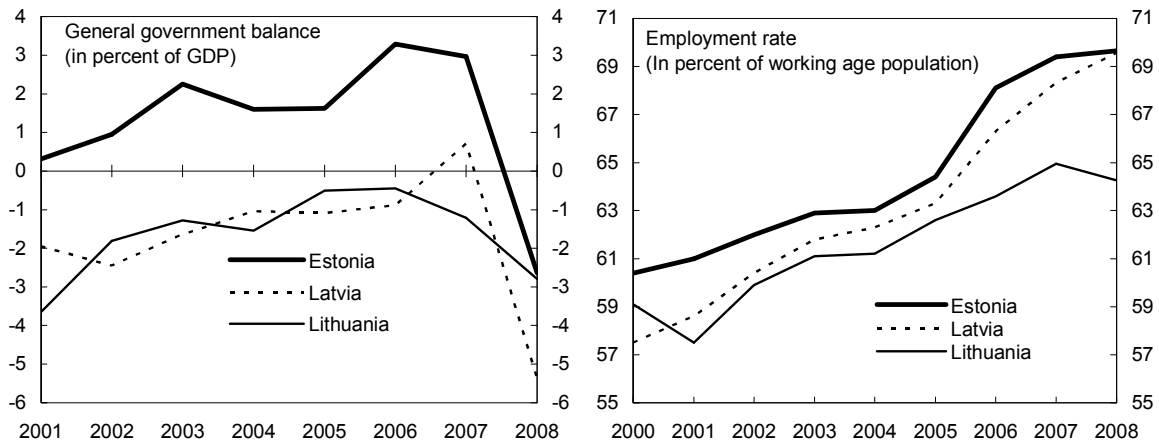
All three countries experienced demand-led booms with accelerating inflation,



large external current account deficits, and rapid credit growth.

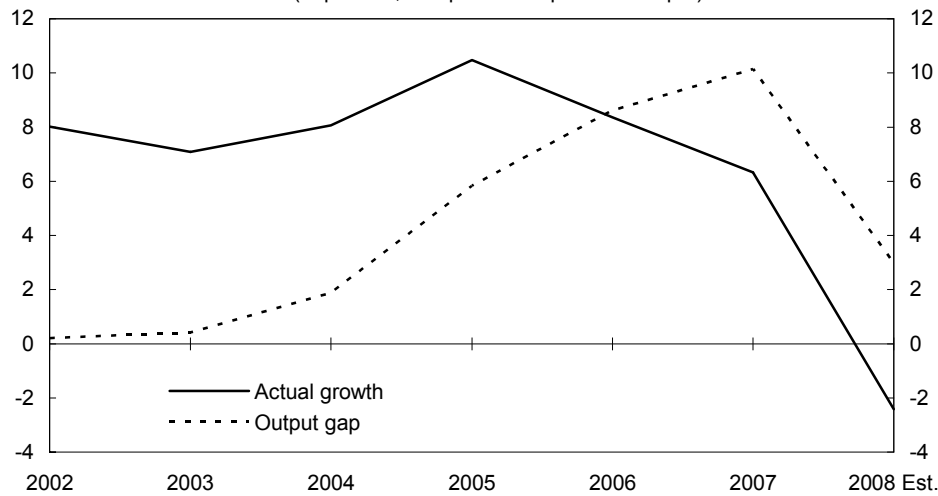


But Estonia demonstrated a significantly larger degree of fiscal prudence and higher labor gains.



Source: Eurostat; UN Comtrade; and IMF staff calculations.
 1/ Annual data for 2008 reflect IMF staff estimates as of January 15, 2009.

Figure 3. Estonia: Growth and Output Gap, 2002-08 1/
(In percent; and percent of potential output)



Sources: Estonian Statistical Office; and Fund staff calculations.

1/ The output gap is measured as the average of gaps obtained from the HP filter and from the production function approach.

3. Like the upswing, the downturn was driven by domestic demand (Figure 4).

Investment sagged in 2007 when Estonia's two largest banks—both subsidiaries of Swedish banking groups—curtailed lending in response to a heightened awareness of risks in their large Baltic exposures. Subsequently the global liquidity crunch in 2007-08 led to a repricing of risk—CDS spreads, interest rate premia and forward premia all rose and Swedish banks' share prices declined

(Figure 5). By 2008, the flow of bank credit relative to GDP had fallen sharply and confidence indicators had wilted. The stock market dropped below its pre-boom level, while housing prices fell 20-30 percent below their peak (Figure 6). In 2008 domestic demand collapsed, producing three quarters of increasingly negative GDP growth.

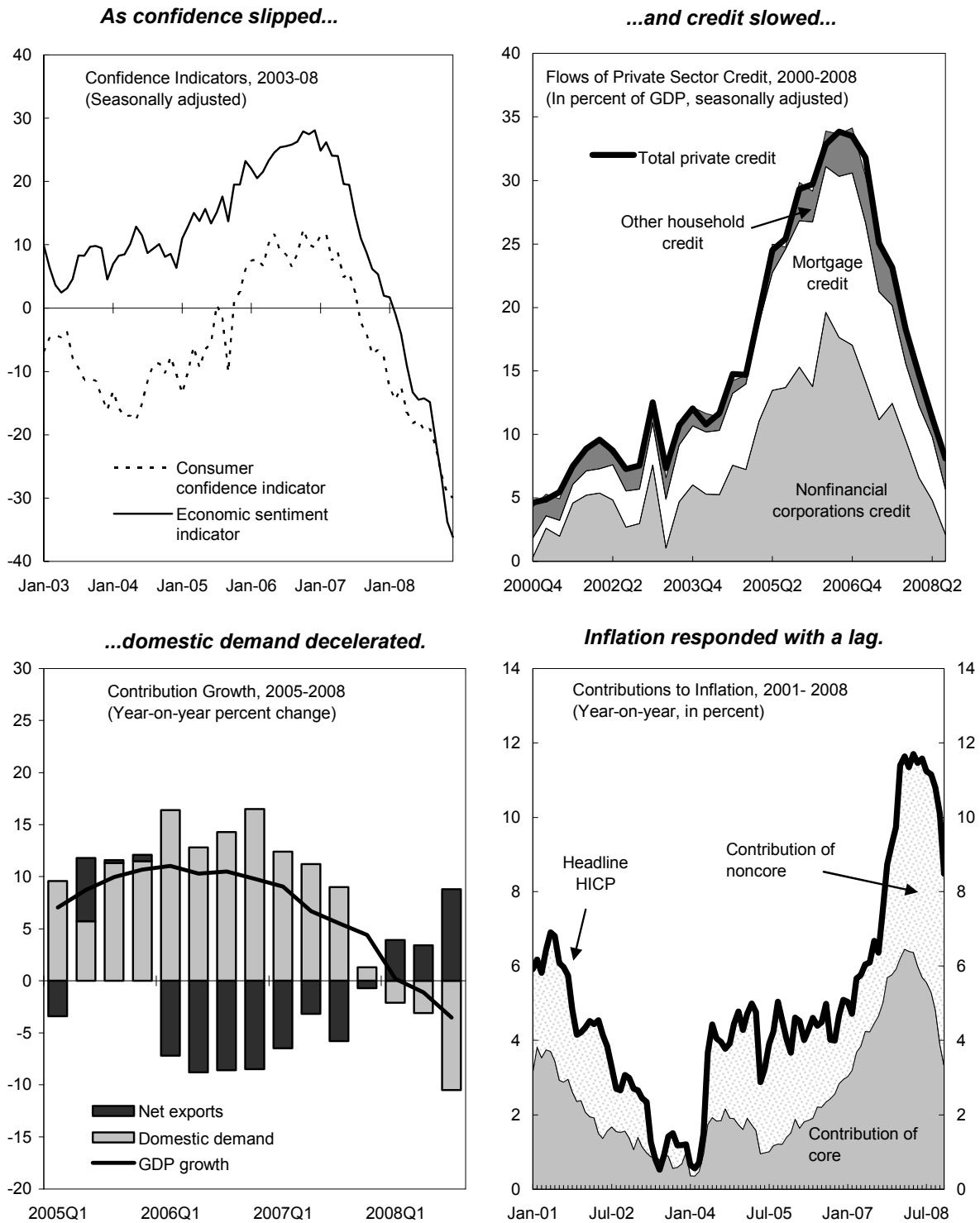
Estonia: Sources of the Demand Slowdown, 2007-08
(Year-on-year, in percent)

	Contributions to GDP growth		
	2007Q1	2008Q3	Change 1/
Domestic demand	12.4	-10.5	-22.9
Consumption	8.4	-0.9	-9.3
Other	4.0	-9.6	-13.6
Net exports	-6.5	8.8	+15.3
Exports	3.5	4.5	1.0
Imports (-)	10.0	-4.3	-14.3
GDP	9.0	-3.5	-12.6

Sources: Estonian Statistical Office; and Fund staff calculations.

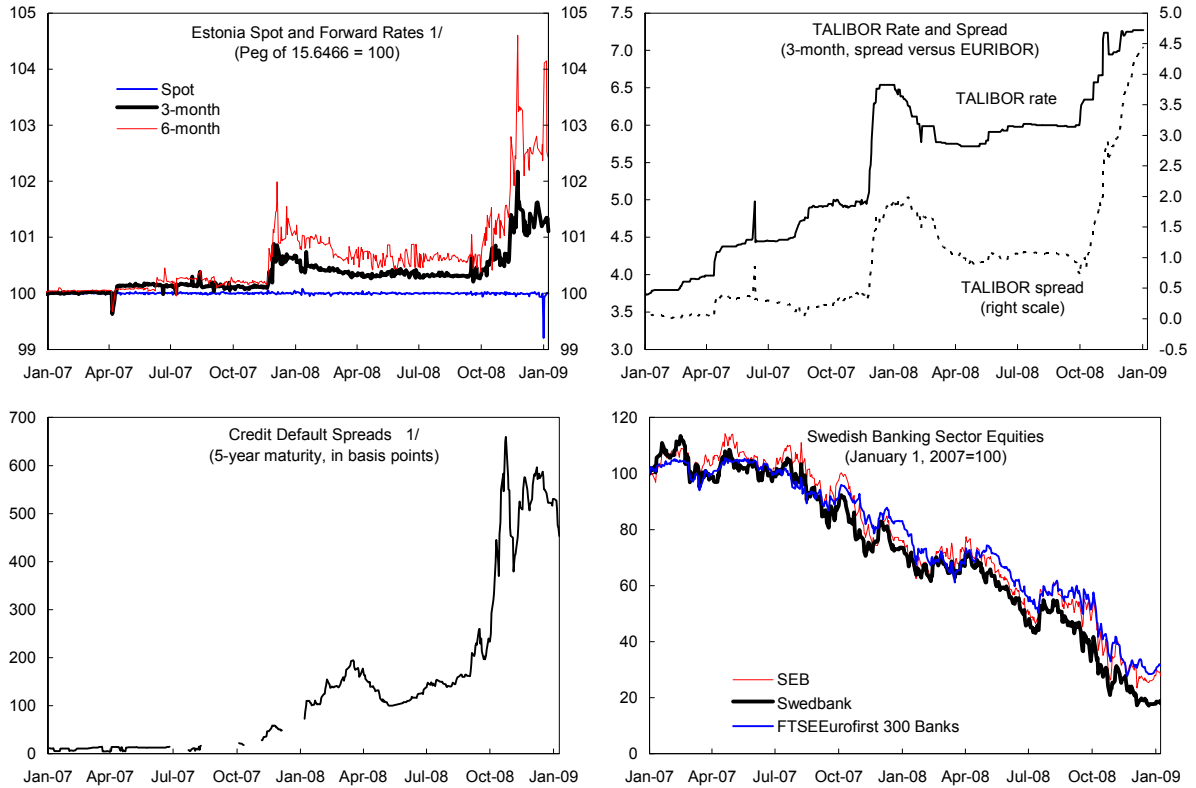
1/ Percentage point difference.

Figure 4. Estonia: The Turnaround in 2007-08



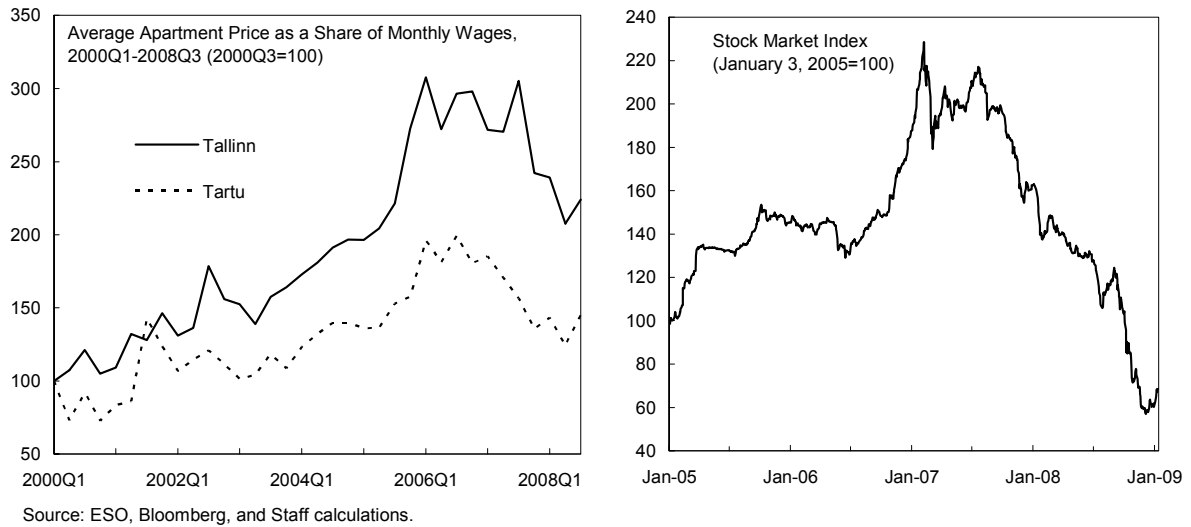
Source: Estonian authorities and IMF staff calculations.

Figure 5. Estonia: The impact of the Recent Global Financial Turmoil, 2007-09



Source: Bloomberg and Staff calculations.
 1/ Breaks in the series reflect periods when there were no quotes.

Figure 6. Estonia: Asset Markets Developments



Source: ESO, Bloomberg, and Staff calculations.

4. **The recession has sharply reduced the external current account deficit** (Figure 7). After swelling to 18 percent in 2007, the deficit receded to an estimated 10 percent in 2008, the lowest in six years. The main factor was the trade balance: imports were pulled down by domestic demand while exports increased modestly, owing to an improvement in prices and a recovery of oil transit trade. A second factor was the decline in profits paid to foreign-owned companies and banks. Competitiveness is being eroded—the nominal ULC-based real exchange rate is appreciating rapidly but the real ULC-based measure shows a much more moderate appreciation.¹ Indeed, Estonia’s market share of world exports has increased only modestly in recent years, unlike the impressive gains registered in 2002–04.

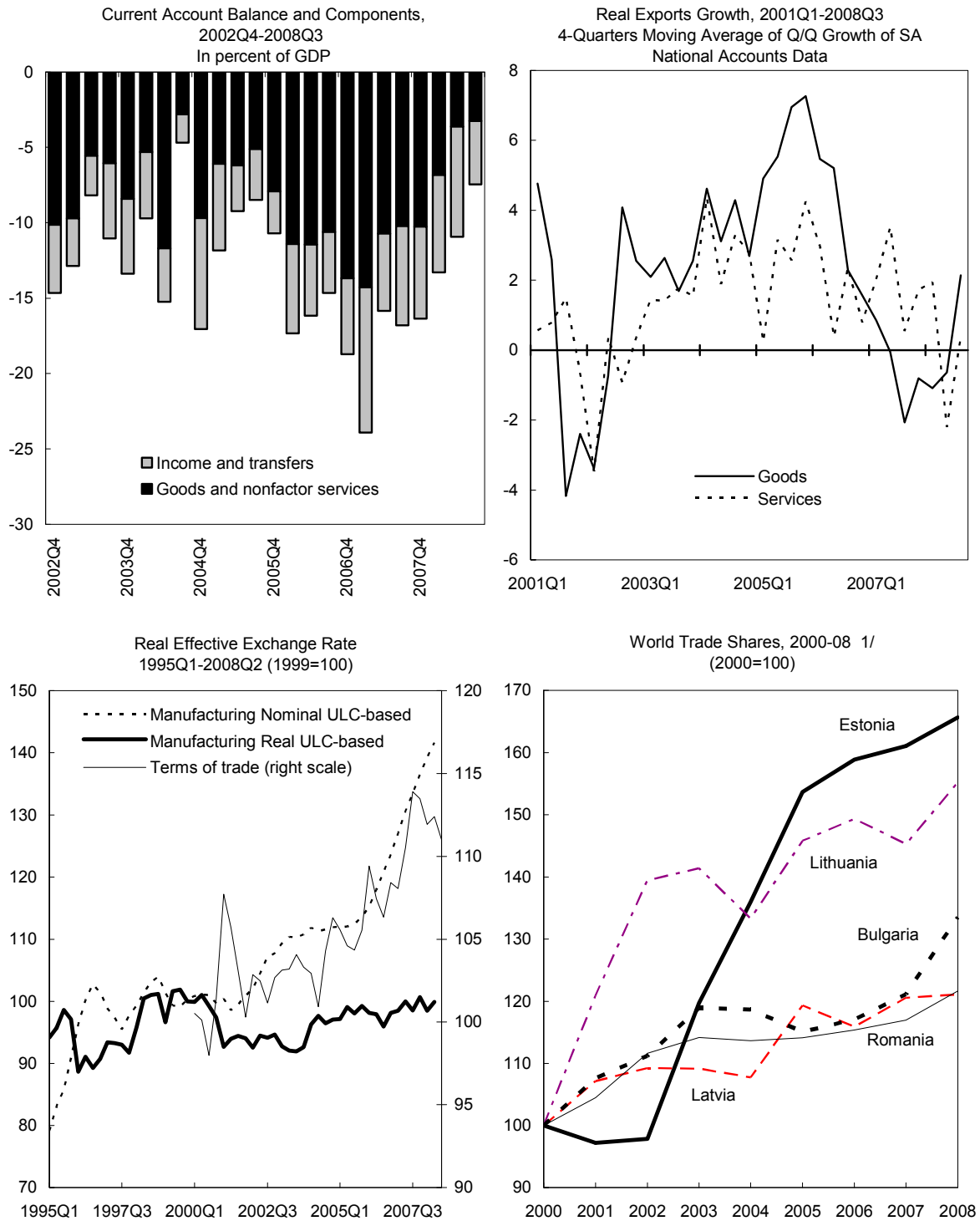
5. **Inflation, which hit an eleven-year high in early-2008, is coming down rapidly** (Figure 4). As in the other Baltic countries, inflation has exceeded the euro area average, reflecting temporary factors and convergence dynamics (Box 2). Inflation rose in 2007 mainly because of external shocks (from food and fuel) and one-off domestic shocks (from administered prices and indirect taxes); it subsequently declined as the external shocks were reversed.² At the same time, core inflation, which accelerated during the boom, is decelerating as the economy weakens.

6. **Labor market conditions were tight until late 2008 but there are signs of rapid easing.** Real wage growth still exceeds productivity growth, compressing profits relative to their strong 2006–07 level, but nominal wage growth has slowed from more than 20 percent a year in 2007 to about 15 percent in mid-2008. Wage growth in construction has collapsed and there are reports of cancelled or reduced wage bonuses in other sectors. And, after eight years of declines, the unemployment rate jumped by more than 2 percentage points in the third quarter of 2008 (Figure 8). Other signs of easing include declining vacancies, increased layoffs, and enterprise surveys (Figure 9) that put labor shortages at the bottom of the list of factors hindering business activity.

¹ The real ULC is the ULC deflated by the producer price index. A constant real ULC in the face of an appreciating nominal ULC suggests that profitability is sustained by the capacity to charge higher prices, perhaps because of a shift to higher value-added goods.

² The authorities frontloaded the adjustment of excises and administrative prices in order to ease the way to meeting the Maastricht criterion when other inflationary impulses fade.

Figure 7. Estonia: External Sector Developments

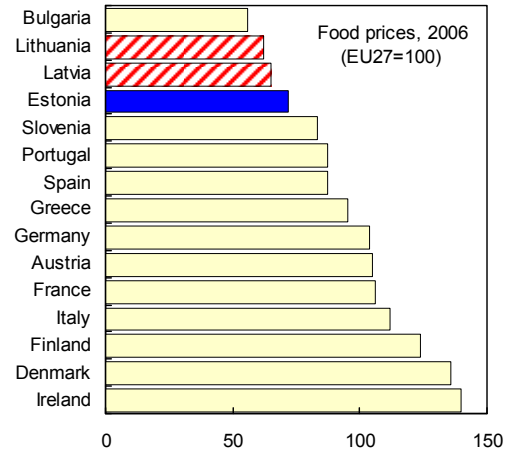


Source: Eesti Pank, Eurostat, ESO, and Staff calculations.
 1/ Data for 2008 reflect IMF staff estimates as of January 15, 2009.

Box 2. Inflation in Estonia and the EU

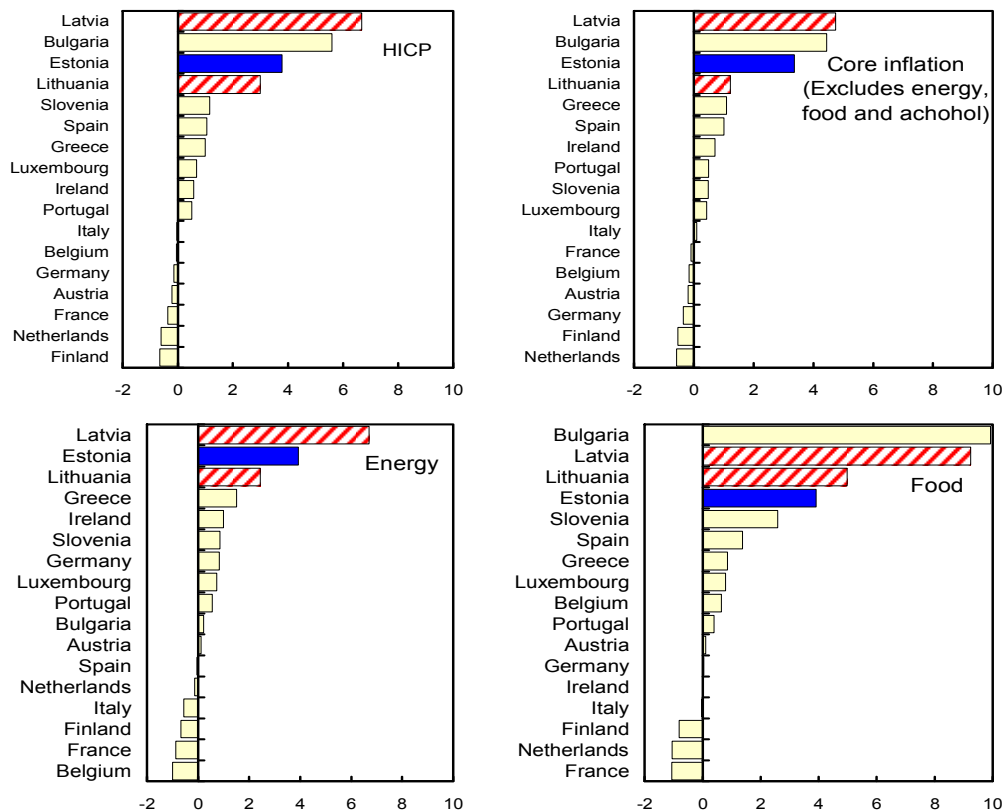
Estonia’s inflation has diverged from the EU average despite the currency peg because of convergence, differences in cyclical positions and energy and food prices.

As in the other Baltic countries, *energy prices* accelerated following the renegotiation of long-term contracts, the linking of gas prices to oil prices and the increase in excises towards EU-mandated levels. *Food prices*, which are still well below EU average, have been catching up. Finally, the *weights* of energy and food in HICPs are substantially higher in Estonia than EU-wide. This alone accounts for 2 percentage points of the Estonia-EU inflation differential.



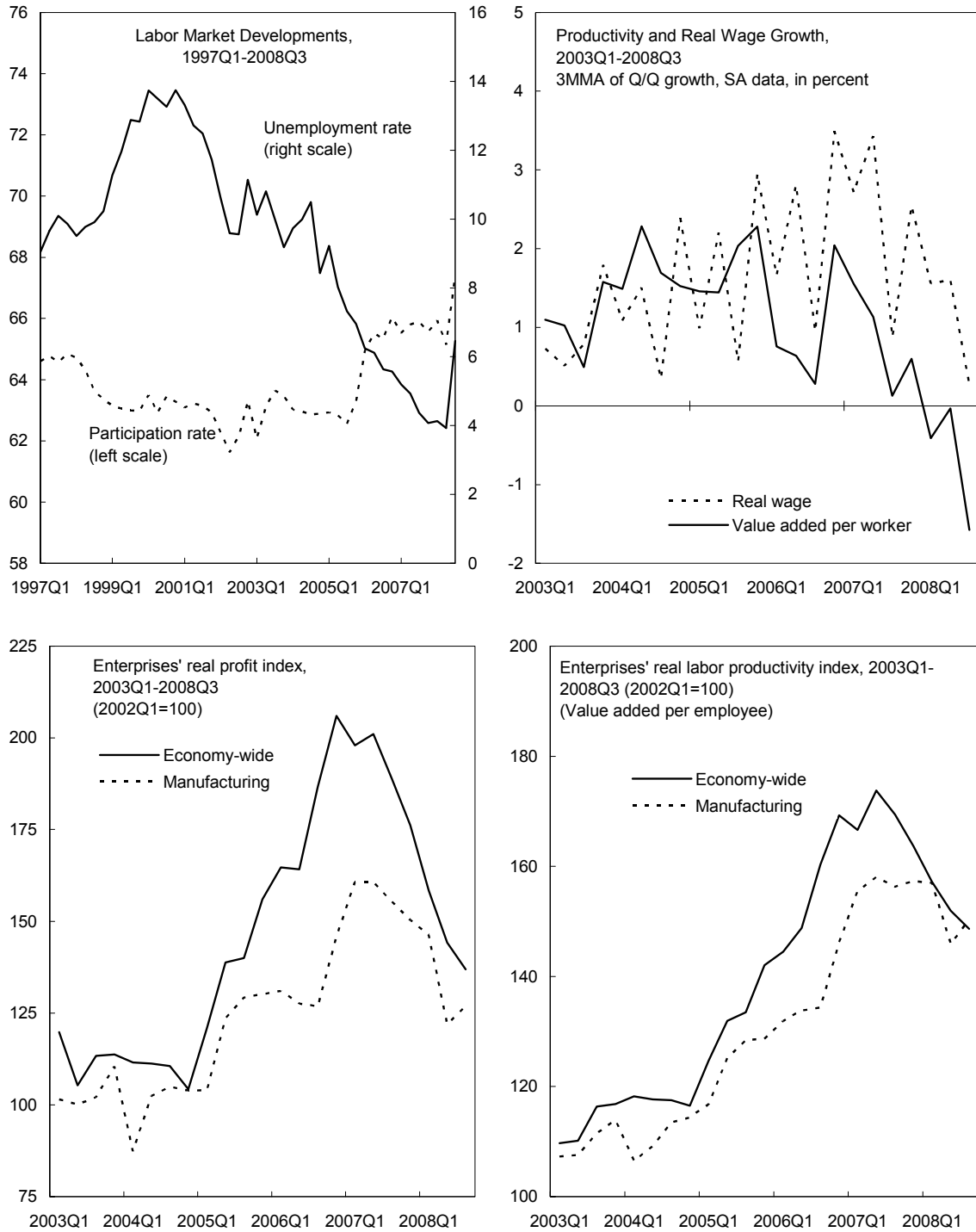
Source: Eurostat and IMF staff calculations.

Inflation differentials vis-a-vis the Euro Area average, 2007-08



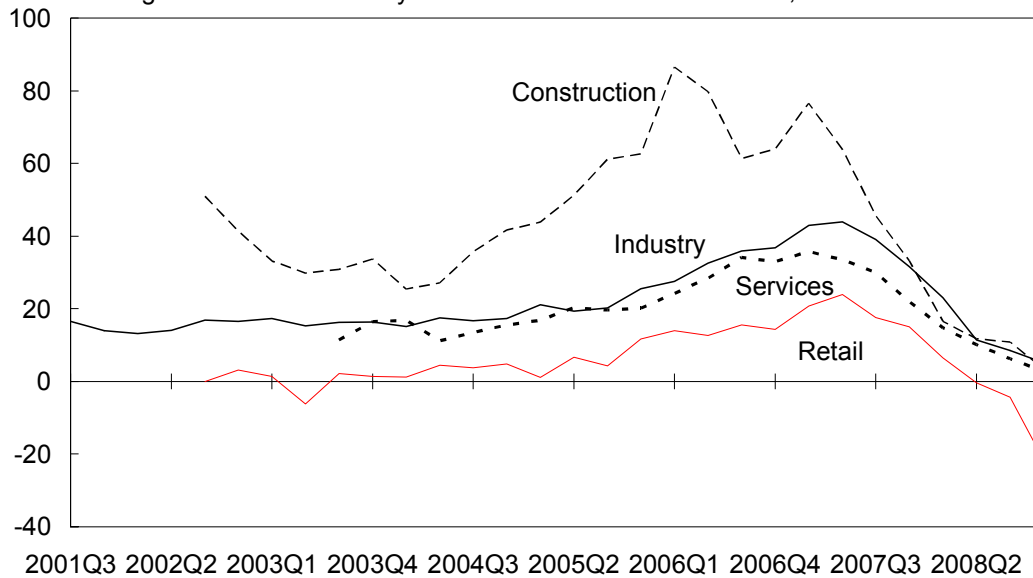
Source: Eurostat, HICP data bank and Fund staff calculations.

Figure 8. Estonia: Developments in the Labor Market and Enterprises' Finances



Source: ESO; Staff calculations

Figure 9. Estonia: Survey Data on Labor Market Pressures, 2001-08 1/



Source: Estonia Institute of Economic Research; and Staff calculations.

1/ The index, which measures the role of labor market shortages in limiting production (industry, construction, services) or changes in employment plans over the next three months (retail), is constructed from the responses of market participants to the business tendency survey.

7. **The financial sector withstood last year's global financial turbulence well, but risks remain elevated.** Since 95 percent of the banking sector (by assets) is owned by large Nordic groups with centralized liquidity management, there is virtually no domestic money market. Estonian subsidiaries and branches were kept liquid—if at high prices—by their parents who in turn benefited from liquidity support and guarantees by the home country authorities. The resilience of the sector was tested twice in 2008. In October, a system-wide run on a large regional bank affected its deposits in Estonia, which declined by 15 percent. The episode caused little systemic damage because liquidity was provided by the parent institution and the deposits moved to the local branch of another Nordic bank. Later in the year, the banking sector was little affected by the crisis in Latvia. As regards capitalization, banks' buffers have been strengthened by high retained earnings (text table) and supported by conservative regulatory limits.³ But banks face increasing risks: the mortgage boom has reduced liquidity and asset quality is being eroded by the recession.

³ The regulatory CAR is 10 percent, higher than the 8 percent Basel requirement. The risk weight on mortgages was 100 percent in 2006. It was reduced to 60 percent with Basel II implementation in 2008 but remains higher than the 35 percent minimum risk weight required by the European Capital Requirements Directive.

Estonia: Financial Soundness Indicators of the Banking Sector

	2004	2005	2006	2007	Mar-08	Jun-08	Sep-08
<i>Capital adequacy</i>							
Regulatory capital as percent of risk-weighted assets	13.37	11.72	13.16	14.78	16.97	18.22	18.34
Capital as percent of assets	9.81	8.64	8.41	8.61	8.73	8.63	8.95
<i>Capital adequacy (on consolidated basis)</i>							
Regulatory capital as percent of risk-weighted assets	11.47	10.72	10.79	10.84	12.11	12.72	12.88
Capital as percent of assets	9.94	8.72	7.61	7.70	8.04	8.66	9.11
<i>Asset quality</i>							
Non-performing loans (NPL) as percent of gross loans	0.26	0.20	0.18	0.44	0.62	1.05	1.55
NPL net of provisions as percent of tier I capital	2.03	1.22	1.56	3.82	5.01	9.40	13.91
<i>Earnings and profitability</i>							
Gross profits as percent of average assets (ROAA)	2.13	1.96	1.70	2.59	2.77	2.76	1.97
Gross profits as percent of average equity capital (ROAE)	20.04	21.04	19.77	30.00	31.57	30.96	21.37
<i>Liquidity</i>							
Liquid assets as percent of total assets	22.30	24.93	19.19	18.12	18.05	17.39	17.64
Liquid assets as percent of short-term liabilities	39.17	39.46	31.98	34.89	34.72	30.27	31.43
Foreign currency loans as percent of total loans	80.4	79.9	78.1	80.50	82.71	84.64	85.68
Deposits as percent of assets	48.5	51.3	51.2	58.50	52.34	53.79	54.88
Loans as percent of deposits	142.9	132.1	144.8	137.52	156.35	153.61	151.60

Source: Eesti Pank.

8. **Estonia's track record of fiscal conservatism has been interrupted by large expenditure increases.** During 2001-06, expenditure ratios were the lowest in the EU. This supported fiscal surpluses that distinguished Estonia from its Baltic neighbors (Figure 2) and, built up a net asset position. But large structural expenditure increases (both the wage bill and pensions rose a cumulative 24 percent in real terms in 2007-08) have pushed the fiscal balance into deficit. For 2008 the impact was compounded by the recession, which helped drive the deficit to an estimated 2.3 percent of GDP despite a supplementary budget featuring expenditure cuts and asset sales. The cyclically-adjusted deficit was larger, nearly 3¼ percent of GDP.

Estonia: Selected Fiscal Indicators
In percent of GDP

	2003	2004	2005	2006	2007 Prel.	2008 Est.
Total revenues and grants	35.6	36.3	37.1	38.6	39.6	38.7
Total expenditure	33.1	34.7	35.5	35.3	36.7	41.0
General government balance	2.5	1.6	1.6	3.3	3.0	-2.3
Cyclically-adjusted balance	2.3	1.0	-0.1	0.7	-0.3	-3.2
Net transfers from the EU 1/	0.7	1.4	0.4	1.1	1.8	1.9
Cyclically-adjusted balance corrected for net EU transfers	1.7	-0.4	-0.6	-0.4	-2.2	-5.1
Fiscal impulse 2/	-0.8	2.1	0.2	-0.1	1.7	3.0
Memorandum item:						
Output gap	0.4	1.9	5.8	8.6	10.1	3.0

Source: Ministry of Finance, Statistical Office, and Staff Estimates and Projections.

1/ Transfers from the EU minus Estonia's transfers to the EU budget.

2/ First difference in the cyclically- and EU funds-adjusted balance, with sign reversed.

III. DISCUSSIONS

9. **The economic contraction is reducing Estonia's imbalances, but new risks have emerged.** The deepening global recession will weaken Estonia's export markets at a time when wage growth has eroded competitiveness. The global credit crunch is restricting capital inflows. The performance of banks' assets will be stressed further by the domestic recession. And the budget is heading towards large deficits unless there is a substantial adjustment. Discussions focused on: the macroeconomic outlook and risks; fiscal and financial sector challenges, with emphasis on policies to increase resilience to adverse macroeconomic developments; and the contingency framework for the financial sector.

A. Macroeconomic Outlook and Risks

10. **The near-term outlook is uncertain.** Growth is likely to recover only after further wage deceleration has allowed a recovery of investment and exports, and higher saving has restored households' financial health. Also a recovery of the regional economies would be needed to support exports and help restore consumer confidence. However, the global outlook is uncertain and the wage response is difficult to predict although, as noted above, there are signs that a labor market adjustment has begun. Since flexible labor market institutions (see Box 3) allow for a swift wage response, a rapid rebound is possible once the global environment improves.

11. **In staff's baseline scenario,⁴ the recession deepens in 2009, with recovery delayed to 2010 (Table 4).**

- The global recession, weak domestic confidence, and a lagged wage adjustment should push growth to -4 percent in 2009 (close to the Ministry of Finance's -3½ percent). Consumption will fall as unemployment rises and households rebuild financial buffers; investment and exports are constrained by reduced profits and weaker domestic and external demand. The current account deficit should improve sharply as low demand slows imports and weak profits reduce income payments.
- The turnaround is projected to start in mid-2010, assuming the global economy recovers. By then, all annual wage contracts will have been renegotiated and accumulated household saving will have created a basis for increased consumption.
- In the medium term, growth will be lower than in recent years because, with full employment, the main drivers are investment and total factor productivity. Indeed, productivity increases will be imperative: with real wages still converging to EU levels, firms relying on low-wage labor will have to restructure or go bankrupt—a process already underway. Staff projects that investment will eventually return to the

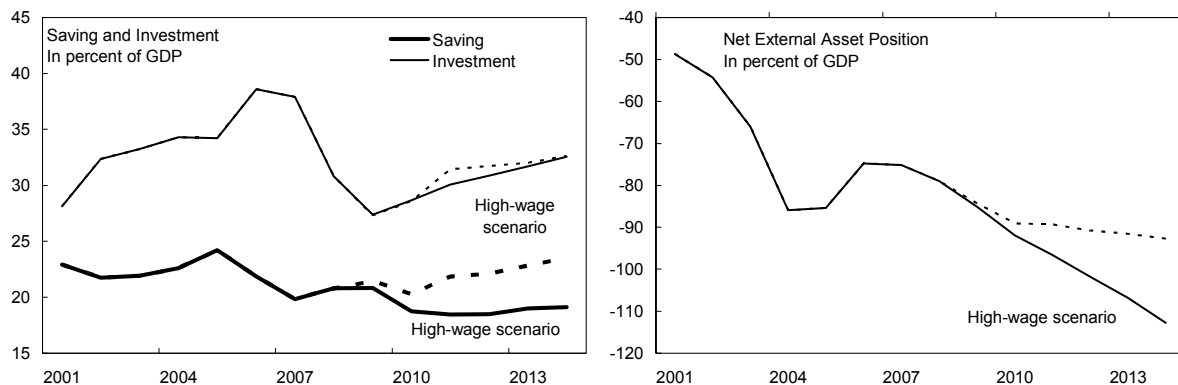
⁴ The baseline scenario incorporates the authorities' announced policy to contain the deficit to at most the Maastricht limit, assumed to take place through cuts in current expenditure.

2002 level while higher interest rates and the prospect of slowing growth will keep the saving rate higher than before the boom. The current account deficit should settle at about 9½ percent of GDP (Figure 10) and the debt ratio would stabilize, albeit at a higher level.

12. **Assuming no further shocks, prices will decelerate sharply in 2009.** The direct impact of the one-off 2008 increases in excises and administrative prices will recede through 2009—vindicating the authorities’ decision to front-load the increases—while second-round effects should be limited by the recession and by the currency board, which should also contribute to rapid deceleration of underlying inflation. The authorities noted that a window of opportunity to meet the Maastricht inflation criterion for euro adoption could therefore open in 2010.

13. **Since the wage response has just begun, staff has prepared an alternative scenario in which wages do not decelerate significantly until 2010 (Figure 10, Table 7).** Continued strong wage growth in 2009 would support higher consumption than in the baseline but would undermine competitiveness, hurting exports and investment. GDP growth would remain below potential through the projection period and a wider external current account deficit would cause faster debt accumulation than in the baseline scenario. The authorities view this scenario as unlikely to materialize given the incipient labor market adjustment.

Figure 10. Salient Features of the Staff's Medium-Term Scenarios, 2001-14



Source: Estonian authorities and IMF staff calculations and projections.

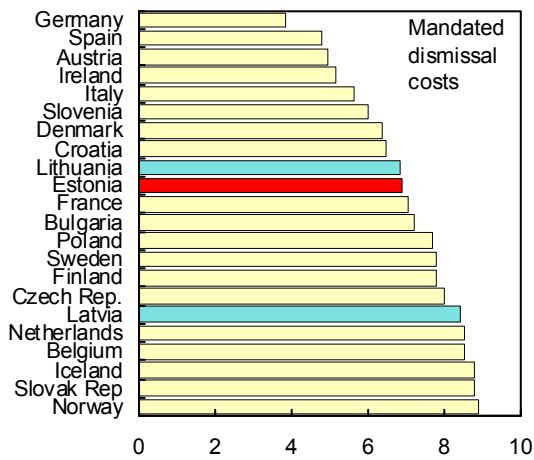
Box 3. Labor Market Flexibility

Estonia's labor market institutions facilitated downward wage flexibility during the recession that followed the 1998-99 Russian crisis, and delivered low unemployment during the upswing (Figure 8). Their strength derives from:

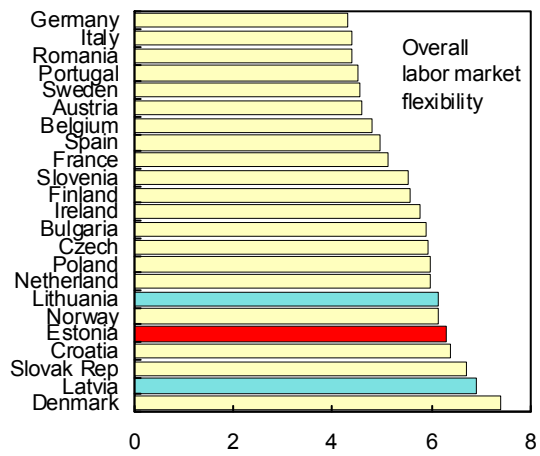
- A liberal legislative framework (though international benchmarking suggests scope for reducing dismissal costs)
- Decentralized wage setting and relatively low minimum wages
- Widespread use of performance-related bonuses (65 percent of enterprises; 15 percent of the wage bill)
- A low trade union density (less than 10 percent of employment, compared to the 25 percent EU27 average)

Labor market institutions are at least as flexible now as in 1998-99 and should once again ease adjustment. However, emigration could hamper downward wage flexibility and amplify employment volatility.

Above average firing costs are a drag...

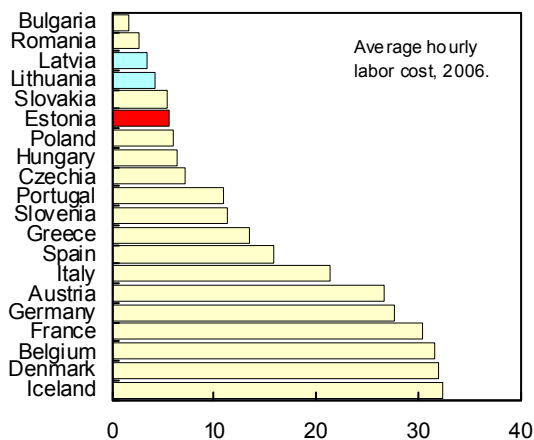


...on an otherwise flexible labor market

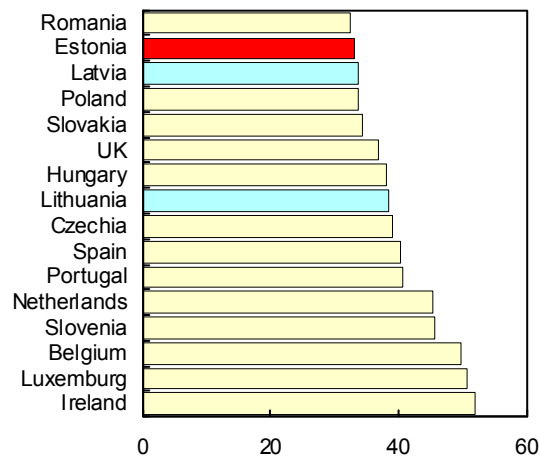


Source: Fraser Institute. Indices on the 0-10 scale, with a higher score indicating more liberal institutions.

Wages are low by EU standards.



The minimum wage is relatively low.^{1/}



Source: Eurostat.

^{1/} Minimum wage in percent of average monthly gross earnings in industry and services, 2005

14. **Other risks to the outlook stem from the still-unsettled global environment.** Chief among them are a sharper-than-expected contraction in export markets and a financial market shock stemming from adverse developments in Nordic parent banks or in other countries in the region. Given the strong trade and investment ties across the Baltics, a severe recession in Latvia or Lithuania would further depress demand in Estonia, aggravating the recession and worsening the performance of the financial sector. Moreover, since Swedish banking groups are dominant in all the Baltics, a financial crisis in either neighboring country or Sweden could spill into Estonia by provoking bank runs or capital flight. These risks underscore the urgency of strengthening the financial sector contingency framework, as discussed below. On the upside, the authorities noted that Estonia's flexible markets and still-low production costs compared to neighboring countries could attract investment by Nordic firms seeking to cut costs in an adverse global environment.

B. External Stability

15. **Estonia's imbalances suggest that the real exchange rate is overvalued, but overvaluation estimates are inconclusive.** The large current account deficit and high wage and price inflation indicate that the real exchange rate has appreciated too rapidly, leading to an overvalued real exchange rate. However, staff calculations, using a variety of standard approaches, show overvaluation falling in a wide range, from 3 to 19 percent. At the low end of the range, the projection-based estimates are consistent with staff's medium term current account projection; the other estimates (with the exception of the REER deviation from historical average) rely on calculations of the underlying current account and of the equilibrium real exchange rate (Selected Issues, Chapter II).

Estonia: Estimates of Real Exchange Rate Overvaluation
(In percent)

	REER Overvaluation 1/
Macrobalance Approach	
Projections-based method 2/	3.1
Elasticities-based method 3/	7.2
External Sustainability Approach 4/	
Projections-based method 2/	5.3
Elasticities-based method 3/	9.4
Equilibrium Real Exchange Rate Approach	18.6
REER Deviation from Historical Average 5/	15.5
Mid-point of overvaluation range	10.8

Source: IMF staff calculations.

1/ Based on end-October 2008 data

2/ Uses the end-point WEO projection (for year 2014) as the underlying current account.

3/ Uses the coefficients of Isard and Faruquee (1998) to estimate the underlying current account.

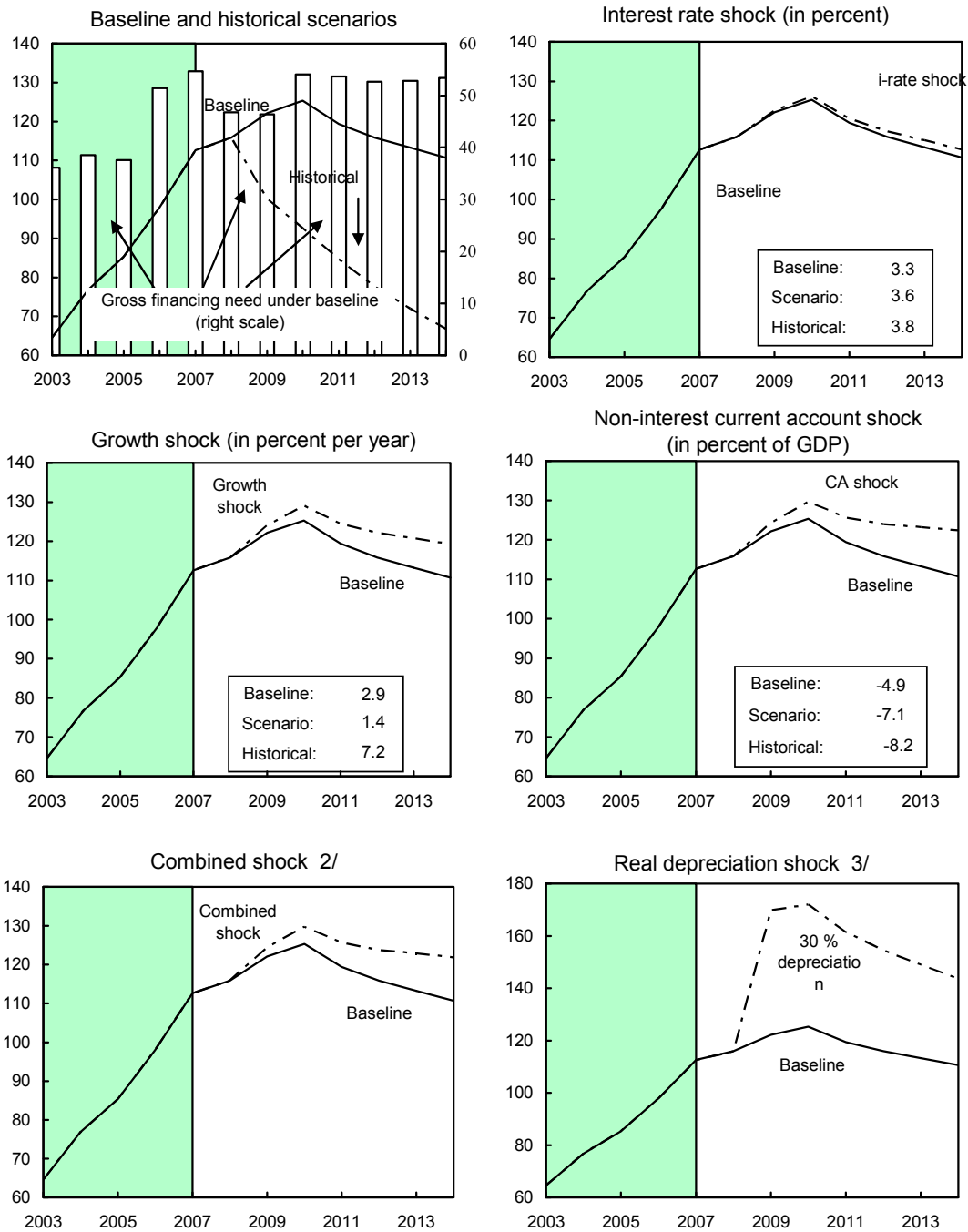
4/ NFA stabilized at the end-September 2008 level (-77 percent of GDP).

5/ Average deviation (of CPI-based REER and ULC-based REER) from their past five-year historical averages.

16. **The authorities argued that the real appreciation remained manageable.** They noted that some of the approaches likely overstate the disequilibrium. First, elasticities-based calculations of the underlying current account use parameters estimated for advanced economies, which may overstate the impact of past changes of the real exchange rate in a converging economy. Second, direct real exchange rate estimates are problematic in an economy undergoing rapid structural change. Staff agreed with the authorities' arguments, which are supported by sensitivity tests (Selected Issues, Chapter II). Overall, while remaining concerned about the recent rapid appreciation and erosion in competitiveness, staff acknowledged that their impact on export performance had been modest to date (Figure 7) and agreed that the overvaluation would remain manageable as long as the labor market adjustment proceeded as expected under the baseline scenario.

17. **The net external debt ratio and the net international investment position (NIIP) are projected to worsen before stabilizing in the medium term.** The worsening of the net asset position increases vulnerability, and the bound tests suggest that a weakening of the current account, slow growth, or a devaluation could significantly increase the debt ratio (Figure 11). However, the gross debt ratio will begin to fall as the economy recovers, while the NIIP (half of which is driven by equity investments) is expected to stabilize near the end of the projection period.

Figure 11. Estonia: External Debt Sustainability: Bound Tests, 2003-14 1/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

3/ One-time real depreciation of 30 percent occurs in 2009.

18. **Balance sheet exposures are also a source of vulnerability** (Selected Issues, Chapter III). Euro-denominated bank loans to (largely unhedged) households and firms contribute to foreign exchange exposures amounting to, respectively, 36 and 42 percent of GDP. These exposures entail exchange rate risk for the borrower and induced credit risk for the lending bank. A second source of vulnerability is banks' reliance on short-term borrowing from their parents to fund long-term domestic lending. This mismatch makes them vulnerable to a liquidity shock if parent banks suddenly withdrew liquidity or stopped lending. If unaddressed, the liquidity squeeze could disrupt the banking sector and create pressure to abandon the CBA.

19. **These vulnerabilities are mitigated by strong institutions and large buffers.** On exchange rate risk, the authorities emphasized that the CBA is robust. The central bank's monetary liabilities are more than fully covered by reserves and euro adoption is a clear exit strategy. Moreover, the CBA is supported by the government's large net creditor position and a political commitment anchored by deep-rooted public support. In addition, commercial banks and the central bank are well equipped to deal with liquidity problems. First, banks' high required reserves, Eesti Pank's excess reserve cover, and the government's liquid external assets are significant buffers. Second, the parent institutions have little interest in withholding liquidity from their Estonian subsidiaries, which they view as strategic investments, and the home authorities have signaled their willingness to support the Baltic operations of their banking groups. These mechanisms worked well in September–October 2008 when a major bank faced a region-wide deposit run. And, third, Eesti Pank has developed a plan for providing ELA to the large foreign-owned banks, with the support of a neighboring central bank, in a manner consistent with CBA rules.

Net asset position by counterpart and currency, September 2008

	In percent of GDP			
	Kroon	FX	Equity	Total
Banks' position				
Government	-4	1	0	-4
Eesti Pank	10	0	0	10
Households	-8	36	0	28
Other private sector	-3	42	-9	30
Nonresidents	0	-47	-14	-61
Corporates' position				
Government	0	-3	-15	-18
Eesti Pank	0	0	0	0
Households	0	0	-8	-8
Banks	3	-42	9	-30
Nonresidents	0	-18	-38	-56
Households' position				
Government	0	0	0	0
Eesti Pank	3	0	0	3
Other private sector	0	0	8	8
Banks	8	-36	0	-28
Nonresidents	0	9	8	18

Source: Estonian authorities and IMF staff estimates.

C. Financial Sector Assessment

20. **Banks performed well through the 2008 global liquidity crisis, but their profitability and capital buffers will be eroded during the recession.**⁵ Continued profitability in 2008 and the still exceptionally low NPL ratios signal resilience but the full impact of the downturn lies ahead: NPL ratios could rise significantly, eating up capital, while the decline in liquidity ratios has increased vulnerability to sudden stops. Going

⁵ See SM/xx/xx for a detailed discussion of banking sector vulnerabilities.

forward, banks' main challenge in the adverse global environment may be to secure enough funding to maintain profitability through loan expansion.

21. **The authorities considered banks' buffers adequate.** Capital buffers are sizable and credit quality sound, helped by a recent strengthening of lending standards. Both should position banks to withstand the anticipated stresses. The authorities do expect NPLs to rise to as much as 5 percent in 2009, but noted that this would be manageable given the currently large capital ratios. Staff agreed, but noted that much of the cushion resulted from reducing the risk weight on mortgages from 100 to 60 percent in the context of the move to Basel 2, a step which seemed inappropriate given the still unsettled real estate market.

22. **The authorities have implemented some key recommendations of the February 2008 FSAP-Update mission (Box 4).** After initially expressing skepticism—owing to moral hazard considerations—about eliminating coinsurance from the deposit guarantee fund (DGF), they took this step during the global turmoil in early October. In line with the EU, they also raised the insurance ceiling. More recently, as mentioned above, the authorities have developed a plan for ELA in case of need. In other areas, the government has prepared draft legislation to accelerate access to budgetary resources in the event of a financial crisis and the Ministry of Finance is drafting legislation for a more flexible bank resolution framework.

Box 4. Findings and Recommendations of the FSAP-Update

The FSAP-update found that Estonia has a sound, well supervised, banking sector but is subject to vulnerabilities from euro-denominated real estate lending and the dependence on short term external funding (see SM/xx/xx). Given these exposures and the risky global environment, the FSSA recommended strengthening the financial safety net. The key recommendations, and the authorities' responses were:

- Create an emergency liquidity assistance capacity. *Agreed. Work is near completion.*
- Strengthen the deposit guarantee scheme by doubling the target size of the DGF, shortening the payout period and eliminating coinsurance. *The authorities consider the target size adequate, but they have eliminated coinsurance and increased coverage.*
- Strengthen the bank resolution framework. *Agreed. Legislation under preparation.*
- Increase staffing at the FSA. *Implemented in Fall 2008.*
- Conduct a joint Baltics-Swedish crisis simulation exercise involving a major regional banking group. *Agreed in principle. Collaboration already close.*
- Implement joint Eesti Pank-FSA macrofinancial stress tests. *Agreed in principle.*

D. Fiscal Policy

23. **The key fiscal challenges are to rein in the budget deficit despite the recession and restore a sustainable fiscal stance over the medium term.** Expenditure increases in the last few years have produced a significant structural deficit, leaving little room for countercyclical policy. Against this background, the authorities' key near-term goals are two-fold: maintaining their fiscal buffer so long as global illiquidity makes borrowing difficult; and ensuring that the deficit does not jeopardize euro adoption by exceeding the 3 percent of

GDP Maastricht ceiling. In the medium term they intend to adjust by enough to meet their traditional goal of budgets that are “in balance-or-better.”

24. **The 2009 budget incorporates difficult measures but is only a first step towards controlling the deficit.** Operational expenditure was cut by an average of 8 percent across ministries. The wage bill was frozen at the 2008 level, with the help of large reduction in civil service employees. And previously-approved income tax cuts were postponed while some indirect taxes and charges were increased. The authorities expected the deficit to be 1.9 percent of GDP but they recognized that lower-than-budgeted receipts from assets sales, worse-than-expected macroeconomic conditions, and poor expenditure control by local governments could make it larger. Staff’s view was that, given its baseline scenario (which projects a deeper recession and lower inflation than the Ministry of Finance’s scenario, thus implying a deficit of 3.3 percent of GDP), these downside risks would drive the deficit well above 3 percent of GDP. This would not present an immediate financing problem given government’s liquid assets of 8½ percent of GDP at end 2008. But it would delay euro adoption and the needed medium fiscal consolidation. The authorities expressed readiness to make further cuts—defense and investments were candidates—if needed to keep the deficit within the Maastricht limit.

25. **The authorities noted that fiscal adjustment over the medium term would require a major effort.** Consolidation was complicated by the budget’s inflexibility: more than 70 percent of expenditure is driven by entitlements and tax earmarks. Thus it would be necessary to reform large components of the budget (such as family support programs and health insurance), and reduce the number of public employees subject to the civil service law. Within this broad framework, some elements of the 2010 budget were already formulated, such as an extension of the wage bill freeze (already agreed) and the further postponement of planned income tax cuts (not yet agreed). Staff welcomed both proposals but noted that, alone, they would not bring the deficit below 3 percent of GDP in 2010 (text table).

Estonia: Fiscal Adjustment in the Baseline Scenario
In percent of GDP

	2007	2008	2009	2010	2011	2012	2013	2014
GG balance under the baseline 1/	3.0	-2.3	-3.3	-3.0	-3.0	-3.0	-2.4	-2.5
Cyclically-adjusted balance corrected for net EU transt	-2.2	-5.1	-4.6	-3.6	-4.6	-5.1	-5.0	-4.7
Fiscal impulse 2/	1.7	3.0	-0.6	-0.9	0.9	0.5	-0.1	-0.3
GG balance with delayed fiscal adjustment 3/	...	...	...	-5.1	-5.5	-6.1	-6.2	-7.2
Budgetary adjustment needed under the baseline 4/	...	...	...	2.1	2.5	3.2	3.8	4.7
Savings from eliminating income tax cut plans 5/	...	...	...	0.4	0.8	1.2	1.2	1.1
Additional adjustment needed (cumulative) 6/	...	...	...	1.6	1.7	2.0	2.7	3.6
<i>Memo item:</i> Output gap under the baseline scenario	10.1	3.0	-4.7	-7.3	-4.1	-2.5	-0.9	0.7

Source: Estonian authorities and IMF staff estimates and projections.

1/ The baseline scenario incorporates from 2010 onwards the authorities’ announced policy to restrict the deficit below the Maastricht limit .

2/ First difference in the adjusted structural balance, with sign reversed.

3/ Assuming no change in policies except for the implementation of previously planned tax cuts from 2010 onwards.

4/ Budgetary savings needed to reduce the deficit to the baseline scenario path.

5/ Budgetary savings from eliminating the planned cuts in the income tax rate and exemptions from 2010 onwards.

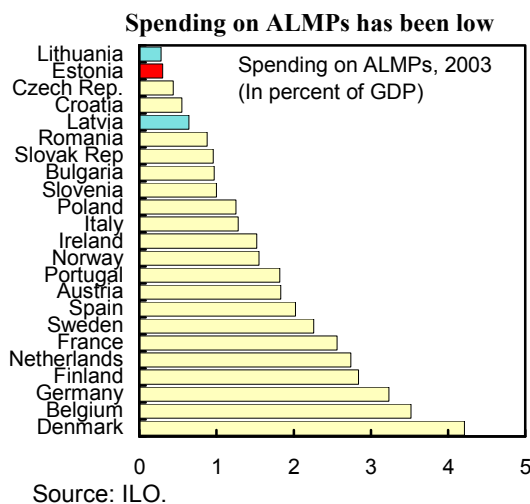
6/ Savings from still unidentified measures.

26. **The authorities plan to address recommendations of the recent FAD mission on fiscal transparency.** The Reassessment Report on Observance of Standards and Codes concludes that Estonia now meets nearly all of the requirements of the Code of Good Practices on Fiscal Transparency—and approaches international best practice in some areas—but highlights potential improvements in budgetary planning, control over subnational borrowing, and documentation of fiscal prospects and risks. The authorities agreed, but implementation is delayed in light of the current focus on containing the deficit.

E. Structural Policies

27. **Market flexibility is critical for the restructuring needed to support medium-term convergence.** Resources should be reallocated from nontraded to traded sectors and from low wage-based to high value-added activities. The authorities emphasized that the reallocation was already underway, and agreed that continued product and labor market flexibility was necessary for it to continue.

28. **In this context, the authorities reconfirmed their commitment to increase labor market flexibility.** They reported that new labor market legislation, approved by parliament last year and effective in mid-2009, would reduce lay-off costs, align labor law with private contract law, streamline procedures, and simplify conflict resolution. At the same time the social safety net would be strengthened by increasing unemployment compensation benefits. Staff supported the move to greater flexibility but advised that the fiscal costs of social protection be clearly assessed and accounted for, and expressed concern about possible adverse labor supply effects. The authorities considered that there was no need to raise immigration quotas, as the current ceilings were not binding, but acknowledged that procedures could be simplified.



IV. STAFF APPRAISAL

29. **The severe recession projected for 2009 will test the flexibility and resilience of the economy.** Since Estonia is very small and very open, there is limited scope for countercyclical policy, so a strong market response is needed to cushion the downturn and underpin the eventual recovery. While consumption should recover after households have strengthened their finances through higher savings, further wage adjustment is needed to revive investment and sustain exports in a more unfavorable environment. Owing to far-reaching reforms in the early 1990s, labor and product markets should have the needed flexibility. The state should support the private sector by securing financial stability. The policies needed are: supporting the CBA, clearing the path for euro adoption, initiating a large medium-term fiscal adjustment, and promoting the stability of financial institutions.

30. **The financial sector weathered severe financial shocks in 2008 owing to large buffers and supportive policies, which have since been strengthened further.** The authorities' decisive response to the global crisis was well-targeted, strengthening financial safety nets and improving the bank resolution framework. The elimination of the coinsurance feature in the DGF removes an important incentive for bank runs while the increase in coverage, in line with EU guidelines, levels the playing field. The development of a framework for providing ELA to large banks is welcome and other planned measures—streamlined access to fiscal resources in a crisis and a more flexible resolution framework—will also be important additions to the crisis management toolkit.

31. **Regional collaboration in financial stability work, which is required given the degree of integration, has been satisfactory and should be sustained.** More important than formal arrangements has been supervisors' routine cooperation and exchange of information. The Swedish authorities' explicit statement that their support to banks should be expected to strengthen all parts of the associated banking groups has also helped; so should the new draft legislation in Estonia creating a framework that facilitates the use of budgetary resources in financial crises. Regularly updated regional crisis simulation exercises would be welcome.

32. **The CBA served Estonia well during the financial crisis but the euro would provide a safer haven.** The global turbulence has underlined the risks of maintaining a separate currency in small open economies and the corresponding benefits of currency union. Robust in design, and buttressed by the fiscal reserve and sound banking sector, the CBA did not come under significant pressure. It therefore was able to anchor expectations and protect the economy from parity swings that would have destabilized the financial system. Nonetheless, the authorities' intention to adopt the Euro as soon as possible remains appropriate, to eliminate the risks associated with a separate currency.

33. **Cyclical developments and policies are bringing the Maastricht inflation criterion within reach but the fiscal criterion is at risk.** While the deceleration of prices is partly the result of exogenous shocks and cyclical factors it also reflects the anchoring effect of the CBA, the well-judged frontloading of administrative price increases, and the preannounced wage bill freeze. Not much more can be done on the inflation front. The focus now needs to be on ensuring that the fiscal deficit remains within the Maastricht limit.

34. **External vulnerabilities are high but the adjustment underway is helping mitigate them.** Given the fixed exchange rate—and eventual euro adoption—Estonia's external imbalances must be addressed in the near term by a contraction of demand and in the medium term by a slowing of real wage growth. The demand shift is already well underway, driven by a more cautious response to risk. The slowing of wage growth is more recent and must be sustained and deepened. While past real exchange rate appreciation has eroded Estonia's exceptionally high competitiveness, profitability should remain adequate if future real wage increases are aligned with productivity growth. The new labor contract law should help insofar as it addresses residual labor market rigidities while improving the social safety net. The incentive structures in the new framework should be monitored carefully in the testing environment of the current recession.

35. **The unsustainable expenditure increases in the last few years leave little room for countercyclical fiscal policy.** Since the effect of fiscal stimulus on demand is modest anyway, fiscal policy in 2009 should focus on slowing the draw-down of the government's liquidity buffers, adhering to the Maastricht deficit and taking the first steps to restore fiscal sustainability. This will require a significant effort in the context of a supplementary budget.

36. **The fiscal position should be strengthened over the medium term.** A modest structural surplus would allow automatic stabilizers to operate without producing deficits during most recessions and position the budget for costs associated with population aging. The adjustment needed to reach this goal is large, and should be phased in gradually. The government's plan to freeze the state budget wage bill for 2009–10 is a welcome first step and should be extended to other levels of government: it creates incentives to reduce inefficiency and sends a signal for wage moderation in the private sector. More broadly, staff welcomes the authorities' intention to review medium term expenditure and revenue policies. Priority should be given to savings that lead to a more efficient allocation of resources.

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

Table 1. Estonia: Selected Macroeconomic Indicators, 2001–09

(In units as indicated)

	2001	2002	2003	2004	2005	2006	2007	2008	2009
							Prel.	Est.	Proj.
National income, prices and wages									
Nominal GDP (kroons, billions)	108.2	121.4	136.0	151.0	173.5	205.0	238.9	256.5	253.0
GDP (euro, billions)	6.9	7.8	8.7	9.7	11.1	13.1	15.3	16.4	16.2
Real GDP growth (year-on-year in percent)	7.7	7.8	7.1	7.5	9.2	10.4	6.3	-2.4	-4.0
Average CPI (year-on-year change in percent)	5.8	3.6	1.3	3.0	4.1	4.4	6.6	10.4	2.7
Average HICP (year-on-year change in percent)	5.6	3.6	1.4	3.0	4.1	4.4	6.7	10.6	3.1
GDP deflator (year-on-year change in percent)	5.2	4.0	4.6	3.3	5.3	7.0	9.6	10.0	2.8
Average monthly wage (year-on-year growth in percent)	13.0	10.9	9.7	7.8	11.4	16.2	20.4	15.0	3.0
Unemployment rate (ILO definition, percent)	12.6	10.3	10.0	9.7	7.9	5.9	4.7	5.3	10.5
Average nominal ULC (year-on-year growth in percent)	5.9	4.2	3.9	0.4	4.1	12.0	14.8	17.7	2.0
Saving-investment balances (in percent of GDP)									
Domestic saving	22.9	21.7	21.9	22.6	24.2	21.9	19.8	20.8	21.4
Private	19.9	17.7	17.5	19.0	19.9	16.8	14.1	20.8	22.6
Public	3.1	4.0	4.4	3.6	4.3	5.0	5.7	0.0	-1.2
Domestic investment	28.1	32.4	33.2	34.3	34.2	38.6	37.9	30.8	27.3
Private	25.2	28.9	30.6	31.6	30.7	34.7	34.0	27.5	23.5
Public	2.9	3.5	2.6	2.7	3.5	3.9	3.9	3.3	3.8
Foreign saving	5.2	10.6	11.3	11.7	10.0	16.7	18.1	10.0	5.9
General government (in percent of GDP)									
Revenue and grants	34.1	35.3	35.6	36.3	37.1	38.6	39.6	38.7	40.8
Expenditure and net lending	33.7	34.2	33.1	34.7	35.5	35.3	36.7	41.0	44.1
Fiscal balance	0.4	1.1	2.5	1.6	1.6	3.3	3.0	-2.3	-3.3
External sector (in percent of GDP)									
Trade balance	-12.5	-15.2	-15.8	-16.6	-13.9	-18.3	-17.6	-12.4	-10.0
Service balance	10.4	8.1	8.4	9.2	7.6	6.5	6.3	6.9	7.2
Income balance	-4.5	-4.4	-5.3	-5.3	-4.1	-5.3	-7.5	-5.7	-3.8
Current account	-5.2	-10.6	-11.3	-11.7	-10.0	-16.7	-18.1	-10.0	-5.9
Gross international reserves (euro, millions)	930	958	1098	1317	1647	2128	2217	2732	2891
in months of imports	2.4	2.4	2.4	2.5	2.5	2.5	2.5	3.0	3.4
Relative to gross short-term debt (including trade credits)	0.7	0.6	0.6	0.5	0.5	0.4	0.3	0.2	0.2
Gross external debt/GDP (in percent) 1/	53.7	58.0	64.6	76.2	86.2	97.9	112.6	115.9	122.1
Net external debt/GDP (in percent) 2/	4.4	10.5	12.9	16.7	18.1	27.4	35.4	36.7	38.8
General government external debt/GDP (in percent)									
Excluding government assets held abroad	2.8	2.8	2.9	2.7	2.7	2.6	1.4	1.3	1.4
Including government assets held abroad 3/	-0.6	-2.5	-5.1	-5.1	-4.9	-6.4	-7.8	-5.0	-1.8
Exchange rate (EEK/US\$ - period average) 4/	17.5	16.6	13.9	12.6	12.6	12.5	11.4	...	...
Money and credit (year-on-year growth in percent)									
Domestic credit to nongovernment	22.2	27.8	27.0	31.2	33.4	41.6	33.0	7.2	-3.3
Base money	-9.8	-1.5	14.6	24.0	33.0	30.7	1.6	28.5	-10.6
Broad money	23.0	11.2	10.9	15.8	41.9	28.2	13.5	5.5	-1.4

Social Indicators (reference year):

Population (2007): 1.342 million; **Per capita GDP** (2007): €11,581; **Life expectancy at birth** (2006): 78.5 (female) and 67.4 (male); **Poverty rate** (share of the population below the established risk-of-poverty line, 2005): 18.0 percent;

Main exports: electrical equipment and parts.

Sources: Estonian authorities and IMF staff estimates and projections.

1/ Includes trade credits.

2/ Net of portfolio assets (including money market instruments), financial derivative assets, other investment assets, and reserve assets held by Estonian residents.

3/ Includes the Stabilization Reserve Fund (SRF).

4/ The Estonian kroon is pegged at 15.6466 kroons to the euro.

Table 2. Estonia: Summary of General Government Operations, 2001–09 ^{1/}
(In percent of GDP)

	2001	2002	2003	2004	2005	2006	2007	2008	2009
							Prel.	Est.	Proj.
Revenue and grants	33.9	35.3	35.6	36.3	37.1	38.6	39.6	38.7	40.8
Revenue	33.3	34.7	34.5	34.2	34.4	35.7	36.6	35.6	35.3
Tax revenue	29.4	30.6	30.4	29.9	30.2	30.6	32.3	31.5	31.4
Direct taxes	18.1	18.8	18.9	18.6	17.6	17.6	19.1	19.5	19.4
Personal income tax	6.6	6.4	6.5	6.3	5.6	5.7	6.1	6.2	6.2
Corporate profits tax	0.7	1.1	1.6	1.7	1.4	1.5	1.7	1.6	1.5
Social security tax	6.3	6.4	6.0	5.7	5.7	5.7	6.1	6.3	6.3
Medical insurance tax	4.1	4.2	4.1	4.1	4.1	4.2	4.6	4.8	4.8
Unemployment insurance tax	...	0.4	0.4	0.4	0.4	0.3	0.3	0.3	0.3
Land and property taxes	0.4	0.3	0.3	0.4	0.3	0.3	0.3	0.3	0.3
VAT	8.0	8.4	8.2	7.5	8.5	9.1	9.3	8.0	8.1
Excises	3.3	3.2	3.1	3.5	3.8	3.5	3.5	3.5	3.5
Other taxes (incl. on intern. trade)	0.0	0.2	0.2	0.3	0.4	0.4	0.4	0.5	0.5
Nontax revenue	3.9	4.0	4.1	4.3	4.2	5.2	4.3	4.1	3.9
Grants	0.6	0.6	1.1	2.1	2.7	2.9	3.1	3.1	5.4
Expenditure	33.6	34.3	33.1	34.7	35.5	35.3	36.7	41.0	44.1
Current expenditure	30.7	30.8	30.5	32.0	32.0	31.4	32.8	37.7	40.3
Expenditure on goods and services	20.0	20.0	19.5	19.8	20.3	20.0	21.5	24.5	26.1
Wages and salaries	6.8	6.9	7.4	7.1	6.9	6.4	6.7	7.5	7.4
Other goods and services	13.2	13.1	12.0	12.6	13.5	13.6	14.7	17.1	18.7
Current transfers and subsidies	10.4	10.7	10.8	12.0	11.5	11.3	11.2	13.0	14.0
Subsidies	0.7	0.9	1.0	1.3	0.7	0.6	0.3	0.3	0.3
Transfers to households	9.7	9.7	9.7	10.2	9.8	9.6	9.6	11.5	12.5
of which: Pensions	6.1	6.0	6.1	6.1	6.0	5.9	6.0	6.9	8.0
Family benefits	1.2	1.1	1.0	1.4	1.3	1.3	1.2	1.4	1.4
Sickness benefits	0.7	0.7	0.6	0.8	0.8	0.8	0.8	1.0	0.9
Unemployment benefits	0.1	0.1	0.2	0.2	0.1	0.1	0.1	0.3	0.3
Income maintenance	0.3	0.3	0.2	0.2	0.1	0.1	0.1	0.0	0.0
Disability benefits	0.4	0.5	0.4	0.4	0.4	0.3	0.3	0.3	0.3
Prescription drug benefits	0.6	0.6	0.5	0.6	0.5	0.5	0.5	0.5	0.5
Other	0.2	0.4	0.5	0.5	0.6	0.6	0.6	1.0	1.0
Transfers to the EU budget	...	...	...	0.6	1.0	1.1	1.2	1.2	1.2
Interest payments	0.2	0.2	0.2	0.2	0.2	0.1	0.2	0.1	0.1
Capital expenditure	2.9	3.5	2.6	2.7	3.5	3.9	3.9	3.3	3.8
Financial surplus (+) / deficit (-)	0.3	0.9	2.5	1.6	1.6	3.3	3.0	-2.3	-3.3
Net lending	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall surplus (+) / deficit (-)	0.4	1.1	2.5	1.6	1.6	3.3	3.0	-2.3	-3.3
Memorandum items:									
Primary fiscal balance (+, surplus)	0.6	1.3	2.7	1.8	1.8	3.4	3.1	-2.1	-3.2
Overall balance, ESA95 basis 2/	-0.1	0.3	1.7	1.7	1.5	2.9	2.7	...	...
Total general government debt									
Excluding government assets held abroad	4.8	5.6	5.6	5.0	4.4	4.3	3.5	3.2	3.3
Including government assets held abroad	1.5	0.3	-2.4	-2.7	-3.1	-4.7	...	...	...
Nominal GDP (kroons, billion)	108.2	121.4	136.0	151.0	173.5	205.0	238.9	256.5	253.0

Sources: Estonian authorities and IMF staff estimates and projections.

1/ Cash basis.

2/ Source: Estonia's Statistical Office.

Table 3. Estonia: Summary Balance of Payments 2002-2014

	2002	2003	2004	2005	2006	2007	Est. 2008	Projections					
								2009	2010	2011	2012	2013	2014
(In millions of EURO)													
Current Account	-825	-985	-1,130	-1,110	-2,192	-2,759	-1,643	-950	-1,372	-1,731	-1,871	-1,923	-2,054
Primary Current Account 1/	-480	-523	-621	-655	-1,504	-1,609	-708	-341	-634	-826	-883	-847	-887
Trade Balance	-1,180	-1,376	-1,603	-1,542	-2,398	-2,686	-2,031	-1,618	-1,909	-2,237	-2,389	-2,551	-2,724
Exports	3,704	4,055	4,730	6,280	7,761	8,076	8,722	8,491	8,690	9,256	10,056	10,928	11,876
Of which : goods for processing	1,146	1,204	804	647	1,281	990	1,069	1,041	1,065	1,134	1,232	1,339	1,456
Imports	-4,883	-5,430	-6,333	-7,823	-10,158	-10,762	-10,754	-10,109	-10,599	-11,494	-12,445	-13,479	-14,601
Of which : goods for processing	-964	-962	-672	-587	-1,174	-970	-969	-911	-955	-1,036	-1,121	-1,214	-1,315
Services Balance	632	733	890	837	849	963	1,136	1,168	1,159	1,295	1,385	1,581	1,762
Receipts	1,800	1,960	2,294	2,571	2,786	3,199	3,462	3,422	3,527	3,784	4,100	4,440	4,809
of which: travel and tourism	585	592	717	783	811	754	815	806	831	891	966	1,046	1,133
Payments	-1,168	-1,227	-1,404	-1,734	-1,937	-2,237	-2,326	-2,254	-2,369	-2,489	-2,714	-2,860	-3,047
Income	-345	-463	-509	-455	-688	-1,150	-936	-609	-738	-905	-987	-1,076	-1,166
Current Transfers	67	119	92	50	45	114	188	109	116	117	120	123	75
Capital and Financial Account	834	1,186	1,367	1,355	2,633	2,737	2,159	1,110	1,508	1,642	1,845	2,167	2,210
Capital Transfers	41	62	69	85	280	173	166	272	289	325	366	407	332
Financial Account	794	1,123	1,298	1,271	2,353	2,564	1,993	838	1,219	1,318	1,480	1,760	1,879
Direct Investment 2/	167	685	554	1,746	548	810	542	326	519	715	778	837	906
From abroad	307	822	771	2,302	1,432	1,962	1,181	709	903	1,118	1,209	1,299	1,399
Outward (by Estonians)	-140	-137	-217	-556	-884	-1,153	-640	-384	-384	-403	-431	-462	-494
Net equity investment 2/	59	32	-44	-1,355	-54	-280	26	-32	-32	-32	-32	-32	-32
Loans and other investments 3/	568	407	788	880	1,858	2,035	1,425	544	732	634	734	955	1,005
of which:													
Banks	340	697	897	531	1,583	2,226	993	32	256	128	128	383	383
Government	-194	-211	-45	-45	-289	-311	375	534	498	528	564	497	547
Monetary Authorities	38	37	11	-44	24	61	-49	0	0	0	0	0	0
Errors and Omissions	50	-53	-18	67	40	110	0	0	0	0	0	0	0
Overall balance	59	148	219	312	481	89	515	159	136	-88	-25	244	157
Memorandum Items:													
(In percent of GDP, unless otherwise stated)													
Current Account	-10.6	-11.3	-11.7	-10.0	-16.7	-18.1	-10.0	-5.9	-8.3	-9.6	-9.6	-9.2	-9.1
Trade balance	-15.2	-15.8	-16.6	-13.9	-18.3	-17.6	-12.4	-10.0	-11.6	-12.4	-12.3	-12.2	-12.1
Non-factor services balance	8.1	8.4	9.2	7.6	6.5	6.3	6.9	7.2	7.0	7.2	7.1	7.6	7.8
Income balance	-4.4	-5.3	-5.3	-4.1	-5.3	-7.5	-5.7	-3.8	-4.5	-5.0	-5.1	-5.1	-5.2
Compensation of employees, net	0.2	0.3	1.1	1.5	1.9	1.4	0.9	1.0	1.1	1.1	1.1	1.1	1.1
Reinvested earnings, net	-4.7	-5.2	-4.1	-6.2	-8.7	-5.4	-5.1	-2.9	-3.7	-4.5	-4.4	-4.3	-4.2
Other income, net	0.1	-0.4	-2.3	0.6	1.5	-3.5	-1.6	-1.8	-1.9	-1.6	-1.8	-2.0	-2.1
Current transfers	0.9	1.4	1.0	0.5	0.3	0.7	1.1	0.7	0.7	0.6	0.6	0.6	0.3
Export growth (in percent)	-1.4	9.5	16.7	32.8	23.6	4.1	8.0	-2.7	2.4	6.5	8.6	8.7	8.7
Import growth (in percent)	5.6	11.2	16.6	23.5	29.9	5.9	-0.1	-6.0	4.9	8.4	8.3	8.3	8.3
Net FDI	2.2	7.9	5.7	15.7	4.2	5.3	3.3	2.0	3.1	4.0	4.0	4.0	4.0
Gross International Reserves (EURO millions) 4/ €	958	1,098	1,317	1,647	2,128	2,217	2,732	2,891	3,027	2,939	2,914	3,158	3,315
In months of imports	2.4	2.4	2.5	2.5	2.5	2.5	3.0	3.4	3.4	3.1	2.8	2.8	2.7
Relative to gross short-term debt (ratio) 6/ 7/	0.6	0.6	0.5	0.5	0.4	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Total external debt 8/													
Gross	58.0	64.6	76.2	86.2	97.9	112.6	115.9	122.1	125.3	119.4	115.9	113.3	110.7
Net 9/	10.5	12.9	16.7	18.1	27.4	35.4	36.7	38.8	40.8	40.6	40.9	40.5	40.6
NIIP	-54.3	-66.1	-85.9	-85.4	-74.8	-75.2	-79.0	-84.3	-89.1	-89.3	-90.8	-91.6	-92.7
General government external debt 10/													
Excluding Govt. assets held abroad	2.8	2.9	2.7	2.7	2.6	1.4	1.3	1.4	1.3	4.2	6.8	8.7	10.5
Including Govt. assets held abroad	-2.5	-5.1	-5.1	-4.9	-6.4	-7.8	-5.0	-1.8	1.3	4.1	6.7	8.6	10.4
Debt Service/Exports of GNFS (in percent)	16.3	20.5	26.2	27.0	30.4	38.1	39.0	41.4	42.4	41.3	39.7	40.1	40.3

Sources: Bank of Estonia and IMF staff estimates and projections.

1/ Excluding interest payments and reinvested earnings.

2/ The large FDI and equity investment flows in 2005 reflect the acquisition of remaining shares of Hansabank, most of which were held by foreigners, by its Swedish parent.

3/ Includes operations in debt securities.

4/ Excludes Government deposits held abroad (including in the SRF).

5/ Changes in gross international reserves may differ from flows implied by overall balance of payments due to valuation changes.

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 4. Estonia: Macroeconomic Framework Under the Baseline Scenario, 2001–14
(in percent of GDP, unless otherwise indicated)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
							Prel.	Est.	Projection					
GDP real growth (percent)	7.7	7.8	7.1	7.5	9.2	10.4	6.3	-2.4	-4.0	0.1	6.3	5.0	5.0	5.0
Contribution to real GDP growth (percent)														
Consumption 1/	n.a.	6.1	5.7	5.3	5.5	7.0	4.3	-1.6	-2.3	0.7	3.1	3.4	3.4	3.4
Investment 2/	n.a.	6.2	5.3	2.7	3.6	7.6	3.3	-7.9	-5.1	1.4	5.3	2.1	2.1	2.1
Exports (goods and nonfactor services)	n.a.	-0.8	5.3	9.9	15.2	9.3	0.0	0.8	-3.4	0.0	3.4	4.8	4.8	4.8
Imports (goods and nonfactor services)	n.a.	-5.1	-7.9	-11.9	-14.2	-17.6	-3.9	5.5	7.1	-2.1	-5.8	-5.5	-5.5	-5.6
Domestic saving	22.9	21.7	21.9	22.6	24.2	21.9	19.8	20.8	21.4	20.3	21.9	22.1	22.8	23.5
Private	19.9	17.7	17.5	19.0	19.9	16.8	14.1	20.8	22.6	22.1	23.7	24.0	24.3	24.7
Public	3.1	4.0	4.4	3.6	4.3	5.0	5.7	0.0	-1.2	-1.8	-1.9	-1.9	-1.4	-1.1
Investment	28.1	32.4	33.2	34.3	34.2	38.6	37.9	30.8	27.3	28.6	31.4	31.7	32.0	32.6
Private	25.2	28.9	30.6	31.6	30.7	34.7	34.0	27.5	23.5	25.6	28.5	28.8	29.1	29.8
Public	2.9	3.5	2.6	2.7	3.5	3.9	3.9	3.3	3.8	3.0	2.9	2.9	2.9	2.8
Foreign saving	5.2	10.6	11.3	11.7	10.0	16.7	18.1	10.0	5.9	8.3	9.6	9.6	9.2	9.1
<i>Memorandum items:</i>														
Fiscal balance 3/	0.4	1.1	2.5	1.6	1.6	3.3	3.0	-2.3	-3.3	-3.0	-3.0	-3.0	-2.4	-2.5
Revenues and grants	34.1	35.3	35.6	36.3	37.1	38.6	39.6	38.7	40.8	38.3	37.5	36.8	36.9	35.9
Expenditure and net lending	33.7	34.2	33.1	34.7	35.5	35.3	36.7	41.0	44.1	41.4	40.5	39.8	39.3	38.4
Cyclically-adjusted balance	1.0	1.3	2.3	1.0	-0.1	0.7	-0.3	-3.2	-1.8	-0.8	-1.8	-2.2	-2.2	-2.7
Net non-debt creating capital inflows ("+" inflow)	7.1	4.4	9.0	6.0	4.3	5.9	4.6	4.5	3.5	4.7	5.6	5.7	5.8	5.4
Capital transfers 4/	0.2	0.5	0.7	0.7	0.8	2.1	1.1	1.0	1.7	1.7	1.8	1.9	1.9	1.5
Net equity investment	0.8	0.9	0.4	-0.5	-12.2	-0.4	-1.8	0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.1
Net foreign direct investment	6.0	2.9	7.9	5.7	15.7	4.2	5.3	3.3	2.0	3.1	4.0	4.0	4.0	4.0
HICP inflation (average, in percent)	5.6	3.6	1.4	3.0	4.1	4.4	6.7	10.6	3.1	2.5	3.0	2.7	2.7	2.7
CPI inflation (average, in percent)	5.8	3.6	1.3	3.0	4.1	4.4	6.6	10.4	2.7	2.3	2.8	2.5	2.5	2.5
Employment growth (average, year-on-year in percent)	0.9	1.4	1.5	0.2	2.0	6.4	1.4	-0.1	-5.0	0.0	0.5	0.5	0.5	0.5
Unemployment rate (percent)	12.6	10.3	10.0	9.7	7.9	5.9	4.7	5.3	10.5	10.5	9.7	9.3	8.9	8.4
Average wage growth (percent)	13.0	10.9	9.7	7.8	11.4	16.2	20.4	15.0	3.0	3.0	5.0	5.0	5.0	5.0
Labor share in total GDP (year on year growth, in percent)	0.6	0.2	-0.7	-2.7	-1.1	4.6	4.8	7.0	-0.8	0.8	-3.4	-1.9	-2.0	-2.0
Output gap (in percent of potential output)	-1.6	0.2	0.4	1.9	5.8	8.6	10.1	3.0	-4.7	-7.3	-4.1	-2.5	-0.9	0.7
Growth rate of potential output (in percent)	6.4	6.0	6.9	6.5	6.4	5.6	4.9	4.4	3.7	2.9	2.8	3.2	3.3	3.4

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

1/ Includes government, private and nonpublic institutions serving households.

2/ Includes private and public capital formation and changes in inventories.

3/ Public savings minus public investment differs from the fiscal balance by the amount of capital transfers received from abroad.

4/ Mainly EU capital grants, all of which are channelled through the budget.

Table 5 Estonia: Indicators of External Vulnerability, 2001–08
(In percent of GDP, unless otherwise indicated)

	2001	2002	2003	2004	2005	2006	2007	Latest Observation	
								Date	
Financial indicators									
Public sector external debt 1/	2.8	2.8	2.9	2.7	2.7	2.6	1.4	...	
Broad money (year-on-year, in percent)	23.0	11.2	10.9	15.8	41.9	28.2	13.5	7.4	Nov-08
Base Money (year-on-year, in percent)	-9.8	-1.5	14.6	24.0	33.0	30.7	1.6	16.2	Nov-08
Private sector credit (year-on-year, in percent) 2/	18.5	19.7	32.5	43.6	64.9	62.1	33.0	10.7	Nov-08
External Indicators									
Exports (percent change, annual average)	4.8	-1.4	9.5	16.7	32.8	23.6	4.1	9.8	Jan-Nov 08
Imports (percent change, annual average)	4.1	5.6	11.2	16.6	23.5	29.9	5.9	-0.6	Jan-Nov 08
Current account balance	-5.2	-10.6	-11.3	-11.7	-10.0	-16.7	-18.1	-10.5	2008Q1-Q3
Capital and financial account balance	4.6	10.8	13.6	14.2	12.2	20.1	17.9	10.8	2008Q1-Q3
Gross official reserves (in euro millions)	930	958	1,098	1,317	1,647	2,128	2,217	2,780	Dec-08
NFA of the consolidated banking system (in euro millions)	785	496	-68	-730	-667	-1,597	-3,404	-4,039	Nov-08
Central Bank short-term foreign liabilities (in euro millions)	1.0	6.4	30.7	32.4	3.1	29.3	84.2	103.5	Sep-08
Short term foreign assets of the financial sector (in euro millions) 3/	630	935	1,605	2,073	3,146	4,019	5,436	3,775	Sep-08
Short term foreign liabilities of the financial sector (in euro millions)	979	1,399	1,733	2,806	2,613	3,715	5,166	9,562	Sep-08
Open net foreign currency position of the financial sector (in euro millions)	1,064	1,576	2,007	2,174	633	506	2,213	3,248	Nov-08
Official reserves in months of imports (excl. imports of goods for processing)	3.2	3.0	3.0	2.8	2.7	2.8	2.7	...	
Broad money to reserves (ratio)	2.8	3.0	2.9	2.8	3.2	3.2	3.5	2.8	Nov-08
Total short term external debt to reserves 4/	1.4	1.6	1.6	1.9	2.1	2.5	3.0	...	
Total external debt 5/	53.7	58.0	64.6	76.2	86.2	97.9	112.6	...	
of which: Public sector debt 1/	2.8	2.8	2.9	2.7	2.7	2.6	1.4	...	
Net external debt 6/	4.4	10.5	12.9	16.7	18.1	27.4	35.4	...	
Debt service to exports of GNFS	13.4	16.3	20.5	26.2	27.0	30.4	38.1	...	
External interest payments to exports of GNFS, in percent	2.8	2.7	2.3	2.3	2.4	2.9	4.7	...	
External Amortization payments to exports of GNFS, in percent	10.5	13.6	18.3	23.9	24.6	33.3	42.9	...	
Exchange rate (per US\$, period average)	17.5	16.6	13.9	12.6	12.6	12.5	11.4	...	
REER (percent change, period average; appreciation (+))	3.4	2.5	3.3	2.4	1.4	1.8	4.6	...	
Financial Market Indicators									
Stock market index 7/	145	212	286	449	664	856	742	275	Dec-08
Foreign currency debt rating 8/	A-	A-	A-	A	A	A	A	A	Dec-08
Money market spread 9/	0.72	0.04	0.23	0.16	0.02	-0.05	2.01	4.10	Dec-08

Sources: Estonian authorities, Bloomberg, Standard & Poor's, and IMF staff estimates.

1/ Total general government and government-guaranteed debt excluding government assets held abroad.

2/ Credit to households and nonfinancial institutions.

3/ Excluding reserve assets of the Bank of Estonia.

4/ By original maturity.

5/ External debt includes money market instruments and financial derivatives.

6/ Net of portfolio assets (including money market instruments), financial derivative assets, other investment assets, and reserve assets held by 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 6. Estonia: Monetary Survey, 2003–09
(In millions of EEK, unless otherwise indicated)

	2003	2004	2005	2006	2007	2008	Proj. 2009
Banking Survey							
Net foreign assets	-1,072	-11,427	-10,429	-24,984	-53,265	-61,007	-59,012
BOE	16,709	20,118	25,750	32,760	33,770	43,390	45,885
Banks	-17,781	-31,545	-36,179	-57,745	-87,035	-104,397	-104,897
Net domestic assets	51,376	69,677	93,102	130,963	173,597	187,930	184,214
Domestic credit	68,933	89,048	117,593	166,916	224,066	242,108	234,000
Net credit to general government	-162	-1,606	-3,314	-4,289	-3,639	-1,966	-1,966
Banks	-157	-1,601	-3,308	-4,284	-3,634	-1,964	-1,964
BOE	-5	-5	-5	-5	-5	-2	-2
Credit to nongovernment	69,095	90,654	120,906	171,204	227,705	244,074	235,966
Credit to nonfinancial public enterprises	221	651	719	617	1,142	1,783	2,050
Credit to private sector	41,769	59,997	98,952	160,360	213,252	231,124	221,632
Credit to nonbank financial institutions	27,105	30,005	21,236	10,227	13,311	11,167	12,284
Other items (net)	-17,558	-19,371	-24,490	-35,952	-50,469	-49,786	-49,786
Broad money	50,304	58,251	82,674	105,986	120,337	126,923	125,202
M1	30,807	36,178	48,673	61,861	59,964	58,478	64,071
Currency outside banks	7,140	7,714	8,747	10,068	9,874	10,092	9,956
Demand deposits	23,667	28,463	39,926	51,794	50,090	48,386	54,116
Time and savings deposits	19,497	22,073	34,001	44,125	60,374	68,445	61,131
Monetary Authorities							
Net foreign assets	16,709	20,118	25,750	32,760	33,770	43,390	45,885
Foreign assets	17,195	20,626	25,799	33,181	35,001	43,442	45,937
of which: currency board cover 1/	13,450	16,672	22,171	28,975	29,439	37,838	33,839
Foreign liabilities	-485	-508	-48	-420	-1,231	-52	-52
Net domestic assets	-3,259	-3,446	-3,579	-3,785	-4,331	-5,552	-12,046
Base money	13,450	16,672	22,171	28,975	29,439	37,838	33,839
Currency issued	8,324	8,895	10,102	11,763	11,762	11,996	8,347
Deposits of commercial banks with the BOE	5,063	7,702	11,985	17,121	17,523	25,842	25,491
Other deposits at BOE	64	75	85	91	155	0	0
Memorandum items:							
Base money multiplier	3.7	3.5	3.7	3.7	4.1	3.4	3.7
Currency-to-deposit ratio	0.2	0.2	0.1	0.1	0.1	0.1	0.1
Velocity (end period)	2.7	2.6	2.1	1.9	2.0	2.0	2.0
Base money (year on year, in percent)	14.6	24.0	33.0	30.7	1.6	28.5	-10.6
Broad money (year on year, in percent)	10.9	15.8	41.9	28.2	13.5	5.5	-1.4
Credit to the private sector (year on year, in perc	32.5	43.6	64.9	62.1	33.0	8.4	-4.1

Source: Bank of Estonia and IMF staff estimates and projections.

1/ Currency board cover is equivalent to base money (e.g., the sum of currency issued plus the kroon liabilities of the BOE in its correspondent accounts).

Table 7. Estonia: Baseline and Alternative Scenarios, 2001–14
(in percent of GDP, unless otherwise indicated)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
							Prel.	Projection						
Baseline Scenario:														
GDP real growth (year-on-year, percent)	7.7	7.8	7.1	7.5	9.2	10.4	6.3	-2.4	-4.0	0.1	6.3	5.0	5.0	5.0
Domestic demand, real growth (year-on-year, percent)	7.3	12.4	10.2	7.9	8.8	14.0	7.5	-7.5	-7.0	2.1	8.0	5.2	5.2	5.2
Domestic saving	22.9	21.7	21.9	22.6	24.2	21.9	19.8	20.8	21.4	20.3	21.9	22.1	22.8	23.5
Investment	28.1	32.4	33.2	34.3	34.2	38.6	37.9	30.8	27.3	28.6	31.4	31.7	32.0	32.6
Foreign saving	5.2	10.6	11.3	11.7	10.0	16.7	18.1	10.0	5.9	8.3	9.6	9.6	9.2	9.1
HICP inflation (annual average, in percent)	5.6	3.6	1.4	3.0	4.1	4.4	6.7	10.6	3.1	2.5	3.0	2.7	2.7	2.7
Employment growth (average, year-on-year in percent)	0.9	1.4	1.5	0.2	2.0	6.4	1.4	-0.1	-5.0	0.0	0.5	0.5	0.5	0.5
Unemployment rate (percent)	12.6	10.3	10.0	9.7	7.9	5.9	4.7	5.3	10.5	10.5	9.7	9.3	8.9	8.4
Average wage growth (percent)	13.0	10.9	9.7	7.8	11.4	16.2	20.4	15.0	3.0	3.0	5.0	5.0	5.0	5.0
Gross external debt	53.7	58.0	64.6	76.2	86.2	97.9	112.6	115.9	122.1	125.3	119.4	115.9	113.3	110.7
Net external debt	4.4	10.5	12.9	16.7	18.1	27.4	35.4	36.7	38.8	40.8	40.6	40.9	40.5	40.6
NIIP	-48.7	-54.3	-66.1	-85.9	-85.4	-74.8	-75.2	-79.0	-84.3	-89.1	-89.3	-90.8	-91.6	-92.7
Alternative Scenario														
GDP real growth (year-on-year, percent)	7.7	7.8	7.1	7.5	9.2	10.4	6.3	-2.4	-4.2	-0.4	2.9	3.2	3.2	3.2
Domestic demand, real growth (year-on-year, percent)	7.3	12.4	10.2	7.9	8.8	14.0	7.5	-7.5	-6.8	2.2	4.3	3.8	3.8	3.8
Domestic saving	22.9	21.7	21.9	22.6	24.2	21.9	19.8	20.8	20.8	18.8	18.5	18.5	19.0	19.1
Investment	28.1	32.4	33.2	34.3	34.2	38.6	37.9	30.8	27.4	28.7	30.1	30.9	31.7	32.5
Foreign saving	5.2	10.6	11.3	11.7	10.0	16.7	18.1	10.0	6.5	9.9	11.6	12.4	12.7	13.4
HICP inflation (annual average, in percent)	5.6	3.6	1.4	3.0	4.1	4.4	6.7	10.6	3.4	2.7	3.0	2.7	2.7	2.7
Employment growth (average, year-on-year in percent)	0.9	1.4	1.5	0.2	2.0	6.4	1.4	-0.1	-6.0	-2.0	-1.0	0.0	0.5	0.5
Unemployment rate (percent)	12.6	10.3	10.0	9.7	7.9	5.9	4.7	5.3	11.4	13.2	13.7	13.8	13.4	13.0
Average wage growth (percent)	13.0	10.9	9.7	7.8	11.4	16.2	20.4	15.0	8.0	3.0	3.0	4.0	5.0	5.0
Gross external debt	53.7	58.0	64.6	76.2	86.2	97.9	112.6	115.9	121.5	124.7	124.5	126.0	127.7	130.3
Net External Debt	4.4	10.5	12.9	16.7	18.1	27.4	35.4	36.7	39.6	43.3	46.0	49.0	51.9	55.7
NIIP	-48.7	-54.3	-66.1	-85.9	-85.4	-74.8	-75.2	-79.0	-85.1	-91.9	-96.6	-101.8	-106.8	-112.7

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

Table 8. Estonia: External Debt Sustainability Framework, 2003–14
(In percent of GDP, unless otherwise indicated)

	Actual					Projections								Debt-stabilizing non-interest current account 6/ -10.3
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014		
Baseline: External debt	64.6	76.8	85.4	97.9	112.6	115.9	122.1	125.3	119.4	115.9	113.3	110.7		
Change in external debt	6.7	12.2	8.6	12.6	14.7	3.2	6.3	3.2	-5.9	-3.5	-2.6	-2.6		
Identified external debt-creating flows (4+8+9)	-12.3	-8.0	-11.4	-2.4	-8.9	5.7	7.5	3.6	-2.9	-1.3	-1.6	-1.7		
Current account deficit, excluding interest payments	9.8	10.6	8.1	14.4	14.6	5.5	0.4	5.7	6.5	5.9	5.4	5.4		
Deficit in balance of goods and services	7.4	8.0	6.3	11.8	11.3	5.5	2.8	4.5	5.2	5.2	4.6	4.3		
Exports	69.2	74.0	78.8	80.5	73.8	74.3	73.7	74.0	72.3	72.9	73.5	74.1		
Imports	76.6	81.9	85.1	92.4	85.1	79.8	76.5	78.5	77.5	78.1	78.2	78.4		
Net non-debt creating capital inflows (negative)	-8.8	-8.9	-10.2	-6.1	-6.1	-6.6	-3.5	-4.6	-5.3	-5.4	-5.5	-5.5		
Automatic debt dynamics 1/	-13.2	-9.7	-9.3	-10.7	-17.4	6.9	10.5	2.5	-4.0	-1.8	-1.6	-1.6		
Contribution from nominal interest rate	1.6	1.7	1.9	2.4	3.5	4.5	5.4	2.6	3.1	3.7	3.8	3.7		
Contribution from real GDP growth	-3.1	-4.4	-6.7	-6.0	-4.9	2.4	5.1	-0.2	-7.2	-5.5	-5.4	-5.3		
Contribution from price and exchange rate changes 2/	-11.7	-6.9	-4.6	-7.0	-16.0	...	...	...	...	...	...	...
Residual, incl. change in gross foreign assets (2-3) 3/	18.9	20.2	20.0	15.0	23.6	-2.5	-1.2	-0.4	-3.0	-2.2	-1.0	-0.9		
External debt-to-exports ratio (in percent)	93.4	103.8	108.4	121.6	152.5	155.9	165.8	169.4	165.2	159.0	154.1	149.3		
Gross external financing need (in billions of US dollars) 4/	3.5	4.6	5.2	8.4	11.4	11.2	10.3	12.3	13.4	14.3	15.5	16.9		
in percent of GDP	36.1	38.5	37.5	51.4	54.6	46.8	46.4	54.0	53.7	52.6	52.8	53.4		
Scenario with key variables at their historical averages 5/						115.9	100.1	92.6	84.7	77.7	72.0	66.7	-14.1	
Key Macroeconomic Assumptions Underlying Baseline														
Real GDP growth (in percent)	7.2	8.3	10.2	8.3	6.3	-2.4	-4.0	0.1	6.3	5.0	5.0	5.0		
GDP deflator in US dollars (change in percent)	25.3	12.0	6.3	8.9	19.5	17.7	-3.8	2.7	3.4	3.0	3.0	3.0		
Nominal external interest rate (in percent)	3.6	3.2	2.9	3.3	4.5	4.6	4.3	2.2	2.7	3.3	3.5	3.5		
Growth of exports (US dollar terms, in percent)	31.0	29.6	24.7	20.6	16.6	15.7	-8.5	3.2	7.4	9.1	9.1	9.1		
Growth of imports (US dollar terms, in percent)	31.9	29.7	21.6	28.0	17.2	7.7	-11.6	5.6	8.5	9.0	8.3	8.5		
Current account balance, excluding interest payments	-9.8	-10.6	-8.1	-14.4	-14.6	-5.5	-0.4	-5.7	-6.5	-5.9	-5.4	-5.4		
Net non-debt creating capital inflows	8.8	8.9	10.2	6.1	6.1	6.6	3.5	4.6	5.3	5.4	5.5	5.5		

Source: Estonian authorities and IMF staff estimates and projections.

1/ Derived as $[-r - g - r(1+g) + ea(1+r)] / (1+g+r+gr)$ times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-r(1+g) + ea(1+r)] / (1+g+r+gr)$ times previous period debt stock. r increases with an appreciating domestic currency ($e > 0$) 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.

INTERNATIONAL MONETARY FUND

REPUBLIC OF ESTONIA

Staff Report for the 2008 Article IV Consultation—Informational Annex

Prepared by the European Department

February 17, 2009

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APPENDIX I. ESTONIA: FUND RELATIONS¹
(As of January 31, 2009)

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

General Resources Account:	SDR Million	Percent of Quota
Quota	65.20	100.00
Fund holdings of currency	65.19	99.99
Reserve position in Fund	0.01	0.01

SDR Department:	SDR Million	Percent of Allocation
Holdings	0.06	N.A.

Outstanding Purchases and Loans: None

Financial Arrangements: None

Projected Obligations to Fund: None

Exchange Rate 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). The de facto exchange rate regime is a “currency board arrangement,” which corresponds to the de jure classification. Estonia has accepted the obligations under Article VIII, Sections 2(a), 3, and 4 of the Fund’s Articles of Agreement, and maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions, except for those imposed for security reasons in accordance with the European Council Regulations set forth in the letter from the Bank of Estonia dated July 9, 2008, and notified to the Executive Board in accordance with Decision No. 144-(52/51) (EBD/08/73, July 9, 2008).

Article IV Consultation:

The 2007 Article IV consultation was concluded by the Executive Board on July 23, 2007.

FSAP and ROSCs:

¹ Updated information relating to members’ positions in the Fund can be found on the IMF web site (<http://www.imf.org/external/np/fin/tad/exfin1.aspx>).

A review under the Financial Sector Assessment Program (FSAP) was completed at the time of the 2000 Article IV Consultation. Further Reports on Observance of Standards and Codes (ROSC) modules were discussed in the 2001 Article IV Consultations and updated during the 2002 Consultation. An FSAP update mission was fielded in February 2008. An FAD mission to reassess the fiscal transparency ROSC was fielded in November 2007. MONEYVAL has prepared an AML/CFT ROSC which will be circulated to the Board in the near future.

Technical Assistance:

TECHNICAL ASSISTANCE FROM THE FUND, 2000–07

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
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

APPENDIX II. ESTONIA: STATISTICAL ISSUES

1. Data provision to the Fund is generally adequate for surveillance purposes, although fiscal data on general government operations are not always timely. A May 2001 data ROSC mission found that the quality of macroeconomic statistics was generally good; international standards and guidelines were generally followed, although coverage of fiscal and monetary data was not complete.
2. Estonia is a subscriber to the Special Data Dissemination Standard (SDDS). Also, the Bank of Estonia (BoE) and the Statistical Office of Estonia (SE) periodically update on their websites a wide variety of data on the key variables for the monetary, fiscal, real, and external sectors.
3. As a member of the European Union and a candidate to join the European Monetary Union, Estonia has markedly upgraded its statistics to comply with European Central Bank (ECB) standards and regulations.

A. Monetary and Financial Statistics

4. The BoE regularly reports monetary data with minimal delay. The data are also published by the BoE on its website. The BoE balance-sheet data (base money and net international reserves) are reported monthly, and are available on the eighth day of the following month. Broad money and its components are available monthly from the BoE on the thirteenth banking day from the beginning of the month. Interest rate updates on domestic and foreign currency transactions are provided monthly on the seventeenth banking day of the month.
5. BoE has adopted the framework of the ECB for the compilation of monetary and financial statistics, which is consistent with the IMF's *Monetary and Financial Statistics Manual*. STA and BoE have completed the data work on mapping Estonia's monetary data into the *Standardized Report Forms* which have been published in the June issue of the *IFS Supplement*.
6. Aggregate financial data are compiled by the BoE and reported on a monthly basis. Data for individual banks are also available on a quarterly basis, and consolidated data on commercial bank reserves, NFAs, and net open foreign exchange positions are available on the eleventh banking day of the month. Commercial bank off-balance sheet data, leverage and liquidity ratios, and short term external debt are available on the eighteenth banking day of the month. Average capital adequacy ratios are available on the thirteenth banking day of the month. Data on non-performing loans are available on the seventeenth banking day of the month.
7. Estonia participated in the Fund's Coordinated Compilation Exercise for Financial Soundness Indicators. Data and metadata on a benchmark set of indicators for 2005 have been posted on the IMF website.

B. Balance of Payments Statistics

8. Quarterly balance of payments and IIP data are compiled by the BoE. Daily exchange rate data are available with a one working day lag. Monthly import/export data are available with a two month lag. Quarterly balance of payments and public and private external debt data are available with a quarterly lag.

C. Government Finance Statistics

9. All fiscal data are published by the Ministry of Finance (MoF). Historical data are also available on SE's website.

- Monthly central government operations data are available with a lag of up to 25 days after the end of the month. The government began reporting monthly data on a consolidated government basis in January 1999 on its Estonian-language web site. Quarterly data on foreign loans and guarantees by the central government are published in Estonian with a monthly lag. The MoF is using one of its two allowed SDDS flexibility options on the timeliness of monthly central government operations data, and have recently started to disseminate these data on the National Summary Data Page.
- Comprehensive annual data on central and local government operations (cash basis) are reported in the *GFS Yearbook*. These data include a statement of operations and the government balance sheet, including data on financial assets and liabilities, both domestic and foreign. Quarterly data for general government, based on the *GFSM 2001* framework, are now regularly reported for inclusion in the *International Finance Statistics*.

D. National Accounts

10. Data on GDP (quarterly, by semester, and annually) are published by SE with a lag of three months after the end of the quarter. Flash estimates of aggregate GDP are available two months after the end of the reference period. The monthly CPI is available seven days after the end of the reference period. Monthly PPI and export price indices are available four weeks after the end of the reference period. Monthly indicators of retail trade, industrial output, industrial sales, are reported approximately six weeks to two months after the end of the reference period. Nominal monthly wage data and quarterly nominal and real wage data are published with a two-month lag.

ESTONIA: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
(As of January 12, 2009)

	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	January 12, 2009	1/12/09	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	December 2008	1/08/09	M	M	M		
Reserve/Base Money	December 2008	1/08/09	M	M	M	O, LO, LO, LO	O, O, O, NA
Broad Money	Nov. 2008	12/15/08	M	M	M		
Central Bank Balance Sheet	Nov. 2008	12/15/08	M	M	M		
Consolidated Balance Sheet of the Banking System	Nov. 2008	12/15/08	M	M	M		
Interest Rates ²	January 9, 2009	1/12/09	D	W	W		
Consumer Price Index	December 2008	1/08/09	M	M	M	O, O, O, O	LO, LO, O, LO
Revenue, Expenditure, Balance and Composition of Financing ³ – General Government ⁴	Q4 2007	3/31/08				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	Q3 2008	12/22/08	Q	Q	Q	O, O, LO, O	O, O, O, O
Exports and Imports of Goods and Services	Nov. 2008	1/09/09	M	M	M		
GDP/GNP	Q3 2008	12/09/08	Q	Q	Q	O, O, O, LO	LO, LO, LO, LNO
Gross External Debt	Q3 2008	12/22/08	Q	Q	Q		
International Investment Position ⁹	Q3 2008	12/22/08	Q	Q	Q		

¹ Any reserve assets that are pledged or otherwise encumbered should be specified separately.

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, assessment and validation, and revision studies.

⁹ Includes external gross financial asset and liability positions vis-à-vis nonresidents.

Statement by the IMF Staff Representative
March 2, 2009

1. **This statement reports on data releases and policy measures since the staff report was issued.** The additional information does not change the thrust of the staff appraisal.

2. **Preliminary data suggest that GDP fell sharply in the last quarter of 2008.** Industrial production plummeted, and the decline in retail sales accelerated. A flash estimate puts real GDP growth at -9.4 percent year-on-year for the 4th quarter (-4.2 percent quarter-on-quarter, seasonally adjusted). These figures would imply that the economy contracted by 3.6 percent in 2008 instead of the 2.4 percent reported in the staff report). Carry-over effects would bring GDP growth to -6.2 percent in 2009 instead of the -4 percent in the staff report. This would produce a larger reduction in inflation and external current account deficit than in the staff report's baseline scenario, but it would also bring a greater deterioration in the performance of bank loans.

3. **The parliament has approved a supplementary budget for 2009 which further tightens the fiscal stance.** The main measures are cuts in operational expenses (including the wage bill) in all ministries and a slowing of the pace of pension increases. The authorities estimate that these and other measures will reduce expenditure by about 3¼ percent of GDP which, under a 6.2 percent economic contraction, would reduce the general government deficit to about 1 percent of GDP. Their objective is to ensure the deficit would not exceed the Maastricht limit even if GDP falls as much as 8 percent in 2009.

 Republic of Estonia: Selected Economic Indicators

	2003	2004	2005	2006	2007
Real Economy	<i>In units as indicated</i>				
Real GDP growth (in percent)	7.1	7.5	9.2	10.4	6.3
Average HICP inflation (in percent)	1.4	3.0	4.1	4.4	6.7
Unemployment rate (ILO definition, percent)	10.0	9.7	7.9	5.9	4.7
Domestic saving (in percent of GDP)	21.9	22.6	24.2	21.9	19.8
Domestic investment (in percent of GDP)	33.2	34.3	34.2	38.6	37.9
Public Finance	<i>In percent of GDP</i>				
General government balance	2.5	1.6	1.6	3.3	3.0
General government debt					
Excluding government assets held abroad	5.6	5.6	5.0	4.4	4.3
Including government assets held abroad 3/	0.3	-2.4	-2.7	-3.1	-4.7
Money and credit	<i>Changes in percent</i>				
Base money	14.6	24.0	33.0	30.7	1.6
Broad money	10.9	15.8	41.9	28.2	13.5
Domestic credit to nongovernment	27.0	31.2	33.4	41.6	33.0
Balance of Payments	<i>In percent of GDP</i>				
Goods and nonfactor services	-7.4	-7.4	-6.4	11.8	11.3
Current account	11.3	11.7	10.0	16.7	18.1
Gross international reserves (euro, millions)	1098	1317	1647	2128	2217
Exchange Rate					
Exchange rate regime	currency board arrangement				
Exchange rate parity	EEK 15.6466=€1				
Real effective exchange rate (percent change, period average; appreciation (+))	3.3	2.4	1.4	1.8	4.6

 Sources: Estonian authorities, and Fund staff estimates.



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

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

IMF Executive Board Concludes 2008 Article IV Consultation with the Republic of Estonia

On March 2, 2009, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV Consultation with the Republic of Estonia.¹

Background

Estonia's economy was already decelerating when the global financial crisis erupted. An outstanding economic performance since the early 1990s had ended in a strong credit boom and overheating in 2005-07. The real estate market had surged, output growth had risen well above potential, inflation had accelerated, and the current account deficit had widened significantly. These widening imbalances eventually raised awareness of increased risks, driving banks to tighten credit in early 2007. This, together with a decline in consumer confidence, triggered an economic slowdown. The global financial crisis brought further credit tightening and decline in confidence, leading to an acceleration of the slowdown in late 2007 and 2008.

The economy is now experiencing its most severe recession since the early 1990's. The downturn is mostly driven by domestic demand, as the credit crunch is squeezing investment and the decline in confidence is reducing consumption. The stock market index, which had soared in 2006, dropped below its pre-boom level, and real estate prices are now more than 20 percent below peak levels. As a result, GDP growth, which had started to decline in late 2007, turned strongly negative last year.

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.

The recession is sharply reducing Estonia's imbalances. The external current account deficit nearly halved between 2007 and 2008, largely due to a demand-driven compression of imports but also helped by a drop in income outflows, reflecting the fall in profits to foreign-owned companies and banks. Exports continued to grow modestly despite an appreciation of the real exchange rate, owing to an improvement in terms of trade and a recovery of oil transit trade with Russia. Inflation, which reached double-digits in mid-2008 because of demand pressures as well as external and internal shocks, is now decelerating sharply as these pressures and the impact of the fuel and food price shocks have reversed.

Labor market conditions have begun to ease. Real wages continued to run ahead of productivity growth in 2008, compressing profits from their (exceptionally strong) 2006-07 level. But nominal wage growth has slowed from over 20 percent in 2007 to about 15 percent last year, and there are reports of cancelled or reduced bonuses. Also, the unemployment rate jumped by more than 2 percentage points in the third quarter of 2008 to above 6 percent, and there is growing evidence of large forthcoming slack in the labor market given the shrinking number of vacancies and widespread news of layoffs.

The financial sector has withstood the global financial turbulence well so far, but risks remain significant. Estonia's banks (almost entirely owned by large Nordic groups with centralized liquidity management) have so far had access to liquidity when needed (although at higher prices) through their parents which in turn benefited from liquidity support and guarantees by the home country authorities. Recently Eesti Pank and the Sveriges Riksbank have concluded an arrangement which will allow for expanded provision of liquidity to subsidiaries of Swedish banks in the event of need. As regards capitalization, strong profits in recent years have strengthened banks' buffers which have traditionally been robust given conservative regulatory limits. But the recession has started to erode asset quality (NPLs more than tripled in 2008, though from a very low level), undermining expected profit.

Estonia's track record of fiscal surpluses has allowed the accumulation of fiscal reserves that are proving crucial for the country's financial stability in this global crisis. However, large structural expenditure increases (particularly in the wage bill and pensions) over 2007-08 have tarnished this record. Together with the recession, they contributed to driving the general government balance into deficit in 2008, for the first time since the beginning of this decade. They have also set the stage for continued deficits over the medium term in the absence of corrective measures.

Executive Board Assessment

Directors commended the Estonian authorities for the progress made in recent years in achieving economic convergence and deepening real and financial ties with the European Union. Economic policies have built up considerable financial buffers, although sizable vulnerabilities have accumulated following a domestic consumption and housing boom that was fueled by high credit growth. With the global deleveraging, Estonia has entered a severe recession that will test the flexibility and resilience of its economy. The domestic demand contraction has already reduced the external current account deficit and lowered inflation. Recovery however will require a revival of foreign

and domestic demand, continued financial stability, and prudent macroeconomic management.

Directors agreed that the currency board arrangement has served Estonia well by anchoring expectations and policies. Nonetheless, contagion risks have heightened. Directors considered, therefore, that euro accession would provide a safer haven. They noted staff's assessment that the real effective exchange rate is somewhat overvalued, but that competitiveness is projected to remain adequate as real wage increases are aligned with productivity.

Directors commended the authorities for their planned substantial fiscal restraint in 2009 that was intended to keep the fiscal deficit within the Maastricht ceiling of 3 percent of GDP. They considered that this fiscal stance would have had only a modest impact on activity, given the open economy and was necessary to support the currency board. Important steps to rein in the fiscal deficit included a freeze on the wage bill for 2009-10, which would also send a strong signal for wage moderation in the private sector, cuts in operational expenditures, and postponement of previously agreed tax reductions and pension increases. Directors encouraged the authorities to achieve a modest structural fiscal surplus over the medium term and supported their intention to review medium-term expenditures and revenue policies.

Directors noted that the financial sector has been thus far resilient to the global crisis. Nevertheless, loan quality will likely suffer as the recession progresses and liquidity buffers may erode further with global deleveraging. Against this background, Directors commended the authorities for their decisive steps to strengthen the bank resolution framework and financial safety nets, including regional safety net cooperation agreements. They welcomed the changes to the deposit guarantee scheme that reduce incentives for bank runs. They endorsed the recent swap agreement between the Estonian and Swedish central banks that underpin a new framework for extending emergency liquidity assistance to large banks, providing an additional liquidity cushion. They supported efforts aimed at improving regional collaboration through continued coordination of supervisory activities and exchange of information.

Structural policies to ensure market flexibility were considered by Executive Directors to be crucial for facilitating real adjustment including a reallocation of resources from the non-traded to the tradable sector and from low wage to high-value added activities. They supported the new labor contract law, which aims to reduce the, albeit limited, labor market rigidities, while improving the social safety net.

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](#) (use the free [Adobe Acrobat Reader](#) to view this pdf file) for the 2008 Article IV Consultation with the Republic of Estonia is also available.

 Republic of Estonia: Selected Economic Indicators

	2003	2004	2005	2006	2007
Real Economy	<i>In units as indicated</i>				
Real GDP growth (in percent)	7.1	7.5	9.2	10.4	6.3
Average HICP inflation (in percent)	1.4	3.0	4.1	4.4	6.7
Unemployment rate (ILO definition, percent)	10.0	9.7	7.9	5.9	4.7
Domestic saving (in percent of GDP)	21.9	22.6	24.2	21.9	19.8
Domestic investment (in percent of GDP)	33.2	34.3	34.2	38.6	37.9
Public Finance	<i>In percent of GDP</i>				
General government balance	2.5	1.6	1.6	3.3	3.0
General government debt					
Excluding government assets held abroad	5.6	5.6	5.0	4.4	4.3
Including government assets held abroad 3/	0.3	-2.4	-2.7	-3.1	-4.7
Money and credit	<i>Changes in percent</i>				
Base money	14.6	24.0	33.0	30.7	1.6
Broad money	10.9	15.8	41.9	28.2	13.5
Domestic credit to nongovernment	27.0	31.2	33.4	41.6	33.0
Balance of Payments	<i>In percent of GDP</i>				
Goods and nonfactor services	-7.4	-7.4	-6.4	11.8	11.3
Current account	11.3	11.7	10.0	16.7	18.1
Gross international reserves (euro, millions)	1098	1317	1647	2128	2217
Exchange Rate					
Exchange rate regime	currency board arrangement				
Exchange rate parity	EEK 15.6466=€1				
Real effective exchange rate (percent change, period average; appreciation (+))	3.3	2.4	1.4	1.8	4.6

 Sources: Estonian authorities, and Fund staff estimates.

**Statement by Jens Henriksson, Executive Director for the Republic of Estonia
March 2, 2009**

The authorities would like to express their appreciation to Mr. Rozwadowski and his team for the thorough and candid policy consultations, and to Mr. Seelig for valuable discussions on the financial sector. The authorities broadly agree with staff's assessment and, as always, consider thoroughly the recommendations put forward.

The Estonian economy has undergone a major transformation over the past decade. The consistent macroeconomic policy framework based on market-oriented policies, openness and a currency board arrangement since 1992, has contributed to building of a broad-based economy and a strong government balance sheet, characterised by minimal public debt and substantial assets.

The currency board arrangement remains the main pillar for economic policies, complemented by the EU membership and the prospective EMU accession as cornerstones for the fast real convergence towards average EU income levels. GDP per capita (measured in PPP terms) has increased by approximately 250 percent since 1997. The fixed exchange rate regime implies that the economy exhibits flexibility in product and labour markets. These assumptions will be thoroughly tested in the current downturn, as the recent sharp deterioration in the external environment has led to a rapid turnaround in domestic economic activity. Like staff, the authorities view the current situation a chance for speeding up the restructuring process of the economy in order to ensure sustained growth in productivity and output over the medium- to long-term.

The authorities have responded vigilantly to an ongoing economic slowdown. The vulnerabilities, especially those related to the current account deficit, credit growth and inflation, have decreased fast, indicating the capability of the economy to adequately react when the cycle turns. The uncertain external environment may pose more challenges for the future, especially for the short-term. However, the defences against a disorderly adjustment are strengthened by the fiscal and liquidity buffers, a strong and well-supervised banking system, ERM2 membership and the policy anchor of the EMU entry. Therefore, Estonia has entered the recession from a relative position of strength.

The outlook for 2009-2010

The Estonian economy is undergoing a sharp, but still an orderly economic adjustment. The authorities remain committed to prudent policies in order to ensure credibility of the economy and to restore the confidence of international investors.

The authorities' macro-economic projections for the Estonian economy have been revised downwards taking into account lower-than-expected growth of the main trading partners. More specifically, the risk scenario of the authorities' fall of 2008 forecasts is now considered to be a baseline, foreseeing a decline in the real GDP by 5–6 percent in 2009 and a slight growth (by about 1 percent) in 2010.

Inflation is declining sharply and is expected to turn negative in the second half of 2009. In January 2009, inflation dropped to 4 percent (y-o-y), down from 7 percent in December 2008,

mainly due to lower motor fuel prices, extensive clothes and footwear sales and a favorable base effect. The authorities do not expect the inflation to exceed 2 percent in 2009.

Labor market flexibility will contribute strongly to a general economic adjustment. Indeed, the evidence over the last six months provides ample evidence that the labor market has been adjusting very rapidly, owing to the decentralized wage setting mechanisms, flexible salary structures and regional integration.

Labor market data for January is expected to confirm preliminary evidence of substantial wage moderation and an increase of part-time work. Tax data suggest that in December, wage growth slowed to 4 percent (y-o-y, down from the range of 15–20 percent) mainly due to a general cancelling of end-year performance bonuses. This is confirmed by recent data on wages with growth in the fourth quarter of 2008 at 6.9 percent. The annual nominal wage growth is expected to be negative in 2009. The registered level of unemployment (generally somewhat lower than the actual unemployment rate in Estonia) reached 6 percent in January 2009. To further streamline the reallocation of labor between economic activities, the new Employment Contract Law was adopted in January 2009 and will enter into force in July 2009. The new law, while raising the flexibility in the labor market, also increases unemployment benefit rates and broadens the range of beneficiaries to enhance security.

External stability

The current account deficit has contracted significantly due to a declining domestic demand, better than expected exports performance of services and the decrease in the outflow of profits via income account. Therefore, the dependence on current foreign financing is receding fast. The deficit in the combined current and capital account decreased from 16.9 percent of GDP in 2007 to 7.5 percent of GDP in the third quarter of 2008. The main contribution came from a narrowing trade deficit, on account of contracting domestic demand. The trade balance is likely to turn into balance or surplus in the coming years, and while the export volumes decrease as a result of a fall in transit trade, the share of higher value added goods in exports will grow.

The authorities note that some indicators in staff's calculations point to real exchange rate overvaluation of the Estonian kroon. Although the calculations are always based on certain assumptions, the authorities accept that the real exchange rate may have been somewhat overvalued in the recent past, but the ongoing adjustment challenges the persistence of the problem. As explained by staff, the authorities have addressed the potential capital account vulnerabilities by improving the financial safety net in coordination with the authorities of home countries of its banks.

Monetary policy

A currency board arrangement remains the over-arching pillar for monetary and financial stability by providing the credible anchor for price expectations over the medium and long term. Having CBA, Estonia has been mimicking life under the Euro area framework already for 17 years, reflecting the flexibility of its markets to adjust. The authorities strongly believe that an orderly entrance to the EMU is the only credible exit strategy from the current monetary arrangement.

As a member of the ERM-2 mechanism since 2004, Euro adoption remains a key policy priority of the Estonian authorities. The currency board has served the economy very well, confirmed by staff during all previous consultations, in keeping the inflation expectations low and serving as an anchor to economic agents' decisions.

Fiscal policy

Fiscal policy has an important role in economic policy making, *inter alia*, to ensure smooth functioning of the currency board arrangement. The Estonian authorities have followed a rule in their State Budget Law that implies an objective of a balanced budget. During the recent years of fast growth, and in concurrence with the Fund's advice, the authorities have run surplus budgets for six years to achieve the objective of a balanced or better budget over the cycle.

However, against the backdrop of the collapse in global demand towards the end of 2008 and the revised projections for 2009, the authorities prepared a negative supplementary budget that was passed by Parliament on February 20. The budgetary consolidation amounts to 3 percent of GDP and was achieved, among other measures, by effectively reducing the government's wage bill. The 2009 deficit will be financed by fiscal reserves and to a limited extent by low-cost project-based borrowing from international financial institutions. The authorities are aware that additional restrictive measures need to be developed for the 2010 budget, and take seriously staff's recommendations on medium-term budgetary planning.

At the same time, the long-term fiscal sustainability is not threatened. The budgetary impact of ageing is among the lowest in the EU. The general government of Estonia has a considerable net asset position, built during the recent years of fiscal surpluses. Financing of the deficit in 2008 has resulted in a decline in central government assets, to around 8½ percent of GDP at the end of 2008, but the fiscal reserves provide a necessary liquidity buffer for the government in these turbulent times. The latest fiscal measures aim at limiting the pace of the exhaustion of these assets.

Financial sector stability

Estonia's banking system is fully integrated with international groups, being the main intermediary of foreign funds to Estonia. 95 percent of Estonia's banking system comprises of the four large Nordic groups having established themselves either as branches or as subsidiaries. Notwithstanding the legal status of local banks, the capital and liquidity management of banks is *de facto* centralized at the group level. The recent experience in the context of global turmoil is providing evidence that intra-group financial flows have been a stable and reliable source of liquidity for the Estonian banking market. In light of regional financial integration, the banking sector measures taken recently by the Nordic authorities have played an additional stabilizing role.

Naturally, this market structure should rely on sufficient liquidity and capital buffers in host countries, on effective supervision, and, most notably, on smooth and efficient cooperation between the home and host authorities. We believe that Estonia's authorities have achieved satisfactory results in this regards, as is also confirmed by the FSSA report.

The capital and liquidity buffers are adequate to sustain the projected slowdown in the economy. In addition, the small size of the corporate debt and equity markets, limited number of market participants combined with virtually no government debt protect Estonia from being attractive to speculators. The high reserve requirement (currently 15 percent) and capital adequacy requirement above the international standard may not be the optimal policies for the long-term, but in the cyclical context and since the introduction of Basel II from January 2008, these are considered necessary safeguards. It is clear that the recent profitability levels will not be achieved for some time to come, but in the fourth quarter of 2008 the banks' profits were still at 17 million EUR level (in 2008, 0.25 billion EUR). An even more important indicator is the cost-to-income ratio of banks, which shows the flexibility of banks in reacting to external developments and has been maintained over the course of a turbulent 2008.

Notwithstanding the rapid deceleration of economic activity and the increase in non-performing loans, the capital adequacy remains high at 19.6 percent level as of end-January 2009, mainly because of retained profits from previous periods. The share of non-performing loans (60 days overdue) in the banks' loan portfolio is increasing from the very low levels, and reached 3.6 percent in end-January 2009. The authorities project it to increase to around 5 percent in 2009. As a reaction, banks have strengthened provisions further. At the same time, the banks consider themselves capable (without any state support) to liquidate collaterals (especially real estate), if necessary.

Credit growth to the private sector decreased significantly in 2008. While reflecting the impact of policy measures of the previous year, this slowdown was further supported by the rapid deterioration of the global conditions, but also of domestic credit demand. In 2009, credit growth might remain flat due to contracting economic activity. Although in the recent years the credit growth related to real estate has been strong, the share of indebted households remains low (22 percent of households according to the latest surveys). In the current environment where euro interest rates are declining, the Estonian borrowers benefit directly from lower debt-service costs on their variable interest rate euro-denominated loans.

The commercial banks in Estonia have sufficient funds. The banks do not see a need for additional state guarantees for the credit to the corporate sector (e.g. to exporting firms). Similarly, the authorities believe there is no need for extensive state intervention in the functioning of the financial system.