

Republic of Estonia—2010 Article IV Consultation

Concluding Statement

Tallinn, December 13, 2010

1. **Estonia has been successful in its all-out efforts to join the euro area on January 1, 2011.** This represents the culmination of 18 years of a fundamentally sound currency board arrangement, supported by a strong commitment to fiscal rectitude that consistently delivered surpluses prior to the crisis. Moreover, despite enduring one of the sharpest contractions in the EU in 2009, the authorities commendably persevered with policies based on satisfying the Maastricht criteria. With the fiscal deficit remaining comfortably below the Maastricht ceiling in 2010, Estonia has earned the distinction of being one of only two EU countries not currently under an Excessive Deficit Procedure.

2. **An ongoing export-led recovery is poised to strengthen, amid inflation surprises.** Mirroring near-term developments in trading partners, exports are expected to continue boosting activity in 2011. Still, growth will remain below the boom-year average, with domestic demand burdened by high household debt, slow real income growth, and double-digit unemployment. Reductions in the latter may likely be hindered by mismatched skills and low labor mobility. Inflation is projected to increase further in 2011 as the full-year impact of global food and fuel prices will be felt even though the impact of administered price increases will wane. Core inflation should remain subdued throughout 2011. While recent wage increases have so far not hurt profitability, they nonetheless warrant close monitoring given losses in price and cost competitiveness in the boom, the slack in the economy, and high unemployment.

3. **Positive surprises to the outlook are possible, but downside risks appear more prevalent at end-2010.** Faster growth is feasible if trading partners' activity proves lasting but this could pose sectoral wage pressures associated with labor market constraints. But the risk of slower growth - including from renewed uncertainty in global financial and sovereign markets and the tail risk of global double-dip recession - has increased. Besides direct trade-related effects, a faltering recovery or if unemployment otherwise becomes entrenched could result in new nonperforming loans (NPLs) weighing on bank's willingness to lend and support the recovery. Estonia could also be exposed to adverse financial spillover effects if foreign parent banks are hit by tail risks.

Against this backdrop, Estonia faces three main challenges to remain on a sustainable growth path:

Safeguarding Fiscal Consolidation and Establishing Counter-Cyclical Policy

4. **Despite an upcoming election year, the 2011 budget keeps a tight rein on expenditures while targeting investment and education and protecting social spending.** The state's administrative expenditures will be frozen at 2010 levels with roughly unchanged operational expenditures. Still, social protection, including a partial recovery of payments to the pension fund, will account for about 30 percent of expenditures. A small increase in the 2011 budget deficit reflects the expiration of one-off revenue factors.

5. **Sticking to the 2011 general government deficit target will be critical for Estonia's fiscal discipline.** This would reaffirm the authorities' commitment to prudent macroeconomic management, and achieving their target will further enhance credibility during Estonia's first year in the euro area. Still, should downside risks materialize, its low public debt and fiscal buffers provide space for automatic stabilizers to operate up to the Maastricht limit. Should revenues surprise on the upside, strict adherence to spending limits will be essential to avert pro-cyclical fiscal policies observed in the boom.

6. **Looking forward, the authorities' medium-term goal of restoring a balanced budget provides a natural benchmark for fiscal policy.** Besides being consistent with EU obligations and ensuring fiscal sustainability, the authorities' medium-term goal would safeguard fiscal buffers - which have played a critical role in negotiating the global financial crisis - needed to bolster Estonia's capacity to cope with shocks.

7. **While spending pressures will continue, under current policies a balanced budget can be broadly achieved.** This will require holding expenditures unchanged after discounting inflation. Demands to boost spending are bound to emerge nonetheless, given the large expenditure cuts in 2009, limited social benefits, and an improving economy. If necessary, offsetting measures should focus largely on the revenue side. Consideration should be given to increasing VAT and environmental and property taxes. These measures could also be used to finance desirable labor tax wedge reductions. This focus should not, however, detract from continuing efforts to improve expenditure efficiency. In any case, the pace of fiscal adjustment should reflect cyclical and medium-term developments and not impair spending in education and investment.

8. **A full-fledged medium-term fiscal framework could support Estonia's consolidation efforts and avert pro-cyclical fiscal policy.** In line with international best practices, such a framework - including binding multi-year expenditure ceilings and underpinned by medium-term deficit targets - can preclude procyclical policies experienced during the boom. This would be achieved by sticking to the spending ceilings - no expansionary supplementary budgets - and allowing fiscal outcomes to adjust to cyclical conditions. Estonia's strong fiscal tradition and its relatively small adjustment needs impart a distinct advantage in operating such a framework. But difficulties may arise in identifying cyclical developments, particularly during the income convergence process.

9. **Such a framework should reflect Estonia's fiscal circumstances.** While a range of fiscal frameworks have been discussed in the EU context, its success in Estonia's will hinge on the dual requirements of simplicity and transparency needed to facilitate communication, verification, and accountability. Its credibility can be bolstered by excluding expenditures of a cyclical nature (such as unemployment benefits) and unpredictable EU structural funds-related spending. There will be a need to address the high proportion of earmarked spending that may complicate expenditure control. Facilitating its operation at the general government level may entail reviewing intergovernmental fiscal arrangements and controls. The Act of Financial Management of Local Municipalities is a step in this direction.

Financing the Recovery While Maintaining Resilience

10. **Estonia's mostly Nordic-owned banks have so far managed to navigate the crisis relatively successfully.** A tightening in credit conditions ahead of the global crisis, low and

declining interest rates, and the practice of rescheduling borrowers' obligations have contained increases in NPLs. A credit crunch has been avoided, and there are incipient signs of easing in lending conditions. Property prices have been slowly recovering but remain well below their pre-crisis peak. At the same time, banks have maintained high capitalization supported by capital increases and reductions in assets. Stress tests conducted by home and host authorities on local and parent banks have indicated resilience to cope with renewed credit risk. Home authorities have kept in place, nonetheless, extensive debt guarantee and financial recapitalization packages stemming from the crisis.

11. Joining the euro system will further lessen financial sector risks, but elevated global financial market tensions and the legacy of the domestic credit bust call for ongoing vigilance. This will require ensuring that:

- the necessary liquidity and collateral systems and procedures are operational so that all banks have effective access to available liquidity facilities from January 1, 2011. Preparations by the Bank of Estonia and major banks are well advanced, but all banks should be encouraged to be fully prepared.
- in collaboration with home supervisors, bank's contingency plans remain effective as lower reserve requirements reduce available buffers and Nordic countries phase out public guarantees in 2011. Parent banks are among those with the largest maturity mismatches and wholesale funding dependency;
- provisioning and capitalisation remain ample in light of ongoing rescheduling of loans, a fairly illiquid property market, a large share of mortgages in negative equity, and high household debt. The authorities are encouraged to continue making use of stress tests to identify vulnerabilities.

12. In coming years, legal and regulatory changes at home and abroad also warrant continued vigilance. Basel 3 requirements, bank levies imposed on parent banks in home countries, and higher Estonian bank contributions to fund the deposit guarantee scheme should strengthen financial stability. But the financial sector, when placed under renewed pressure, may engage in undue risk-taking activities or regulatory arbitrage. In such cases, a readiness to make prompt use of prudential tools is essential. Estonia's new household debt restructuring law and the shortening of the bankruptcy period can help address debt overhang. Still, it will be essential that its implementation not undermine financial intermediation nor harm confidence in a rules-based system. The law rightly stresses the role of out-of-court settlements, but its procedures could still overburden the court system whose input remains central to the process. On the basis of a close monitoring of its implementation, and drawing lessons from the experience of the recently introduced corporate rehabilitation law, a broad review of the insolvency framework should be undertaken in due time.

13. The high integration with Nordic financial systems requires continued efforts to develop effective cross-border and national crisis management and resolution mechanisms. A legislative package, pending in parliament, can help by allowing nationalization and aligning the deposit guarantee scheme with EU directives. But there remains a need to strengthen further the authorities' powers (e.g., to ensure irreversibility of resolution decisions) and expand available tools in close collaboration with home authorities of parent banks (e.g., powers to swiftly implement transfer of assets and liabilities without third-party consent). The 2010 Nordic-Baltic MOU on crisis

management - a pioneering step in cross-border cooperation - provides an ideal framework to identify obstacles and joint solutions for coordinated decision making and bank resolution. Concretizing further the published ex ante criteria for crisis related burden sharing would be desirable. In this context of cross-border cooperation, the authorities may wish to consider putting in place a pre-financed crisis resolution fund.

Fully Deploying Potential Resources and Restoring Competitiveness

14. **Harnessing Estonia's potential requires employing all its resources and continued increases in productivity and competitiveness.** From a cyclical perspective, the previous boom-induced gap between real wages and productivity appears to be narrowing. The longer term challenges are well addressed in the "Estonia 2020" competitiveness strategy. Besides safeguarding Estonia's stable macroeconomic and business friendly environment, supported by flexible labor markets, these goals will entail facilitating reallocating resources to the tradable sector. Estonia's active labor market policies (ALMP) - geared at ensuring that workers acquire the skills demanded by the economy - are key to address the skill mismatch legacy of the construction boom. In this regard, the authorities have increased resources devoted to education and training, including the work practice, pilot voucher, and business start-up schemes. They have also sought to address the schemes' rigidities. Still, there will be a continuing need to review their effectiveness, exploit programs' synergies and potential efficiency gains in the provision of ALMP as well as vocational and tertiary education. Furthermore, boosting productivity and competitiveness will require climbing up the technology and quality ladder. In this regard, the authorities have recently increased R&D expenditures and improved access to its financing. Continued use of EU structural funds in support of life-long learning and needed infrastructure improvement can also support sustainable human capital development, increase labor mobility, including geographically, and establish a solid foundation for rising living standards.

We thank the authorities for their hospitality and open and fruitful discussions.