INTERNATIONAL MONETARY FUND

Staff Country Reports

November 2004
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Republic of Estonia: 2004 Article IV Consultation—Staff Report; 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 2004 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 2004 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 18, 2004, 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 September 29, 2004. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its November 8, 2004 discussion of the staff report that concluded the Article IV consultation.

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

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

Selected Issues Paper

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

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INTERNATIONAL MONETARY FUND

REPUBLIC OF ESTONIA

Staff Report for the 2004 Article IV Consultation

Prepared by Staff Representatives for the 2004 Consultation with Estonia

Approved by Alessandro Leipold and Matthew Fisher

September 29, 2004

- A staff team comprising Messrs. Haas (Head), Lutz, and Stavrev (all EUR) visited Tallinn during June 7–18, 2004.

- The mission met the Governor of the Bank of Estonia, the Ministers of Finance, of Economy, of Social Affairs, and members of their staffs, as well as representatives of trade unions, and the private financial sector. Mr. Ross, Senior Advisor, Nordic-Baltic Executive Director's Office, participated in the concluding discussions. On the way back from Tallinn, Mr. Haas met in Brussels with EC officials to discuss ERM II entry issues.

- Estonia acceded to the European Union on May 1, 2004, and entered into the exchange rate mechanism (ERM II) on June 27, 2004, while unilaterally maintaining its currency board which fixes the Estonian kroon to the euro.

- The authorities published the Concluding Statement of the mission and intend to publish this staff report.

- The right of center coalition government (Res Publica, the Reform Party, and the People's Union) has been in power since April 2003. The next parliamentary elections are scheduled for 2007.

- Estonia has accepted the obligations of Article VIII (Sections 2, 3, and 4), and maintains no restrictions on payments and transfers for current international transactions, except for those imposed in compliance with relevant UN Security Council resolutions and the measures adopted by the EU within the framework of the Common Foreign and Security Policy. All such restrictions have been notified to the Fund pursuant to Decision 144-(52/51).

- Estonia subscribes to the Special Data Dissemination Standard. Data provision is timely and facilitates effective surveillance (Appendix I).

- In concluding the 2003 Article IV consultation on October 22, Directors commended the authorities for their commitment to a prudent fiscal policy. However, in light of the large current account deficit and Estonia's currency board, most Directors were of the view that a more proactive fiscal policy would be required to maintain macroeconomic stability. Directors also noted that the country's currency board had served the country well and noted that confidence in it continued to be strong.

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I. Introduction

1. **Estonia's economic performance has been among the best of the new EU countries over the last decade; it acceded to the EU on May 1, 2004 and joined ERM II at the end of June**. The country has achieved considerable nominal convergence, with all indicators at levels better than the average of the other new EU members (Figures 1 and 2). In addition, Estonia has been among the fastest growing of the accession countries. This has resulted in remarkable progress toward real convergence—per capita GDP has almost doubled since 1993, reaching around 45 percent of the EU average in 2003 in PPP terms. However, the external current account deficit has deteriorated appreciably and remains a cause of concern.

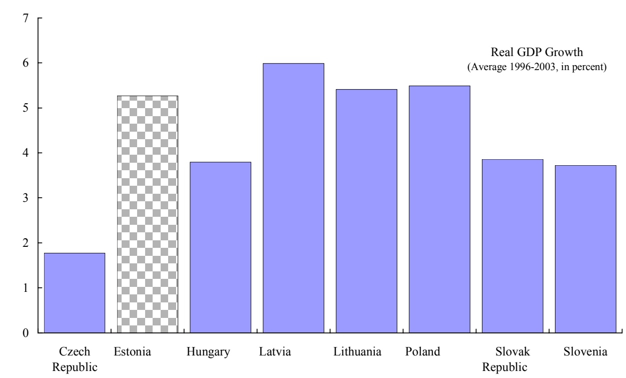
Estonia has achieved nominal convergence...

	Fiscal balance	Debt	Inflation	Interest rate
	(In percent of GDP)		(In percent)	
Estonia	*2.4*	*5.9*	*1.3*	*4.8*
New EU member countries 2/	-3.7	33.3	3.0	5.8
Czech Republic	-5.4	19.5	0.1	4.8
Hungary	-5.9	56.3	4.6	8.2
Latvia	-1.8	14.5	2.9	5.1
Lithuania	-1.5	27.0	-1.7	4.8
Poland	-6.1	45.6	0.7	6.8
Slovak Republic	-3.6	43.4	8.6	5.4
Slovenia	-1.4	27.0	5.6	5.3

Sources: IFS; and country authorities; data for 2003.

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

...and was among the fastest growing new EU members



2. **The macroeconomic and financial sector policies pursued by successive governments since independence have been broadly in line with those proposed by the Fund (Box 1)**. The authorities regard Estonia's cooperation with the Fund as having been helpful in keeping the course of economic reforms steady despite nine governments in the first 10 years of independence, contributing to Estonia's successful transition.

II. Background

3. **Economic activity has been gathering strength with the improvement in the external environment**. Real GDP growth accelerated to 6.8 percent (year-on-year in 2004Q1) from 5.8 percent in 2003Q1, driven by domestic demand and supported by technology sector exports, which have benefited from the recovery in demand in Estonia's major trading partners. The negative contribution to growth of net exports has thus declined.

Selected Indicators, 1999-2004
(In units as indicated)

	1999	2000	2001	2002	2003	2004 Proj.
Real GDP (year-on-year in percent)	-0.1	7.8	6.4	7.2	5.1	5.8
Private consumption	-2.7	8.5	5.9	9.9	5.4	9.5
General government consumption	2.9	1.1	1.8	5.9	5.8	5.0
Gross fixed capital formation	-15.6	14.3	13.0	17.2	5.4	8.0
Exports	0.7	28.3	-0.2	0.9	5.7	8.0
Imports	-5.2	28.3	2.1	3.7	11.0	8.5
Average CPI (year-on-year in percent)	3.3	4.0	5.8	3.6	1.3	3.0
Unemployment rate (ILO definition, percent)	12.2	13.7	12.6	10.3	10.0	8.1
Fiscal Balance (in percent of GDP)	-4.3	-0.6	0.4	1.1	2.4	0.8
Current Account Deficit (in percent of GDP)	4.4	5.5	5.6	10.2	13.2	11.2

Sources: Estonian authorities and Fund staff estimates.

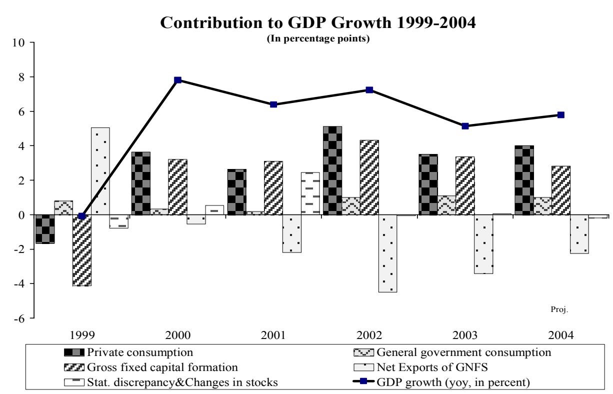
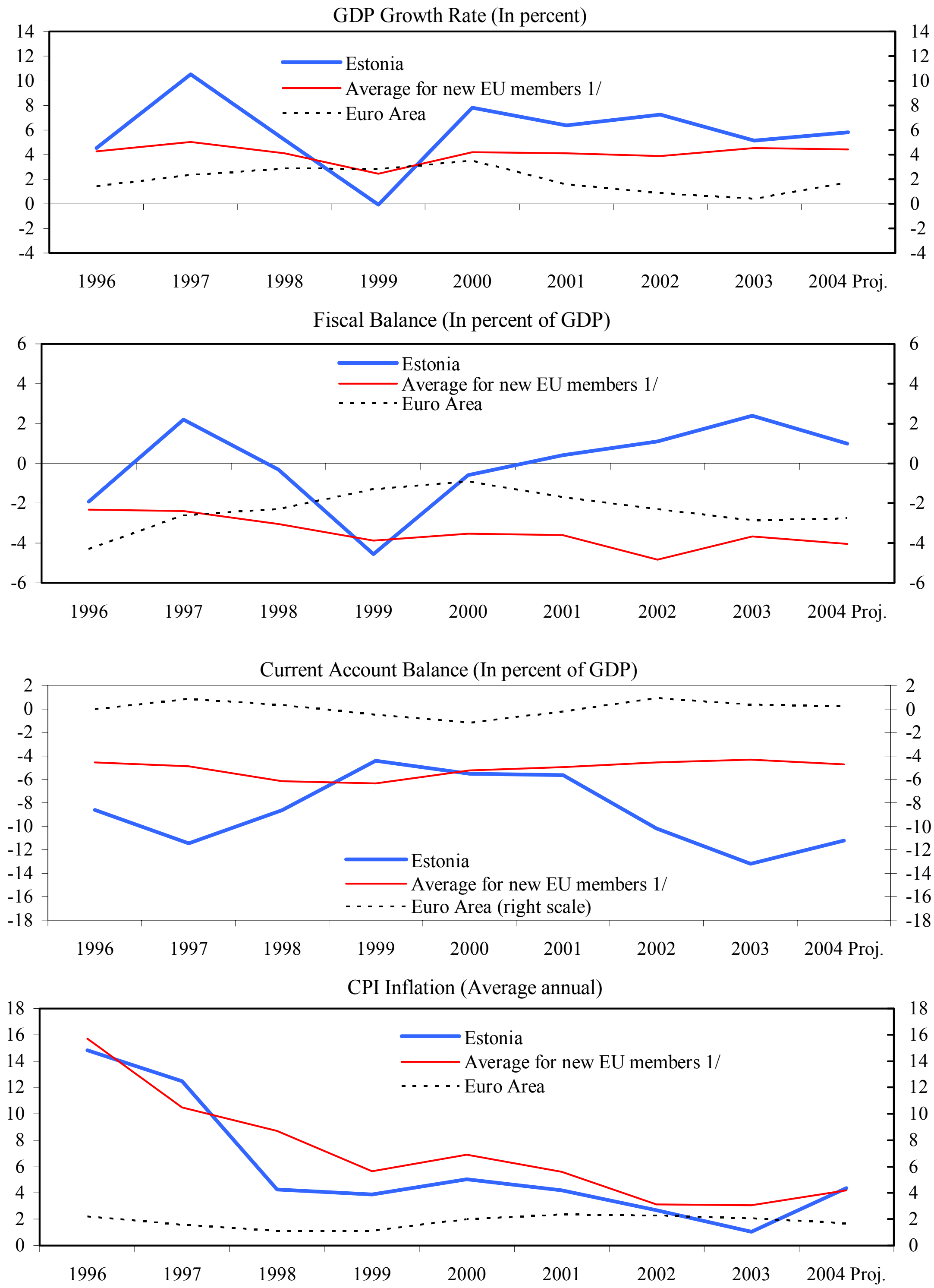


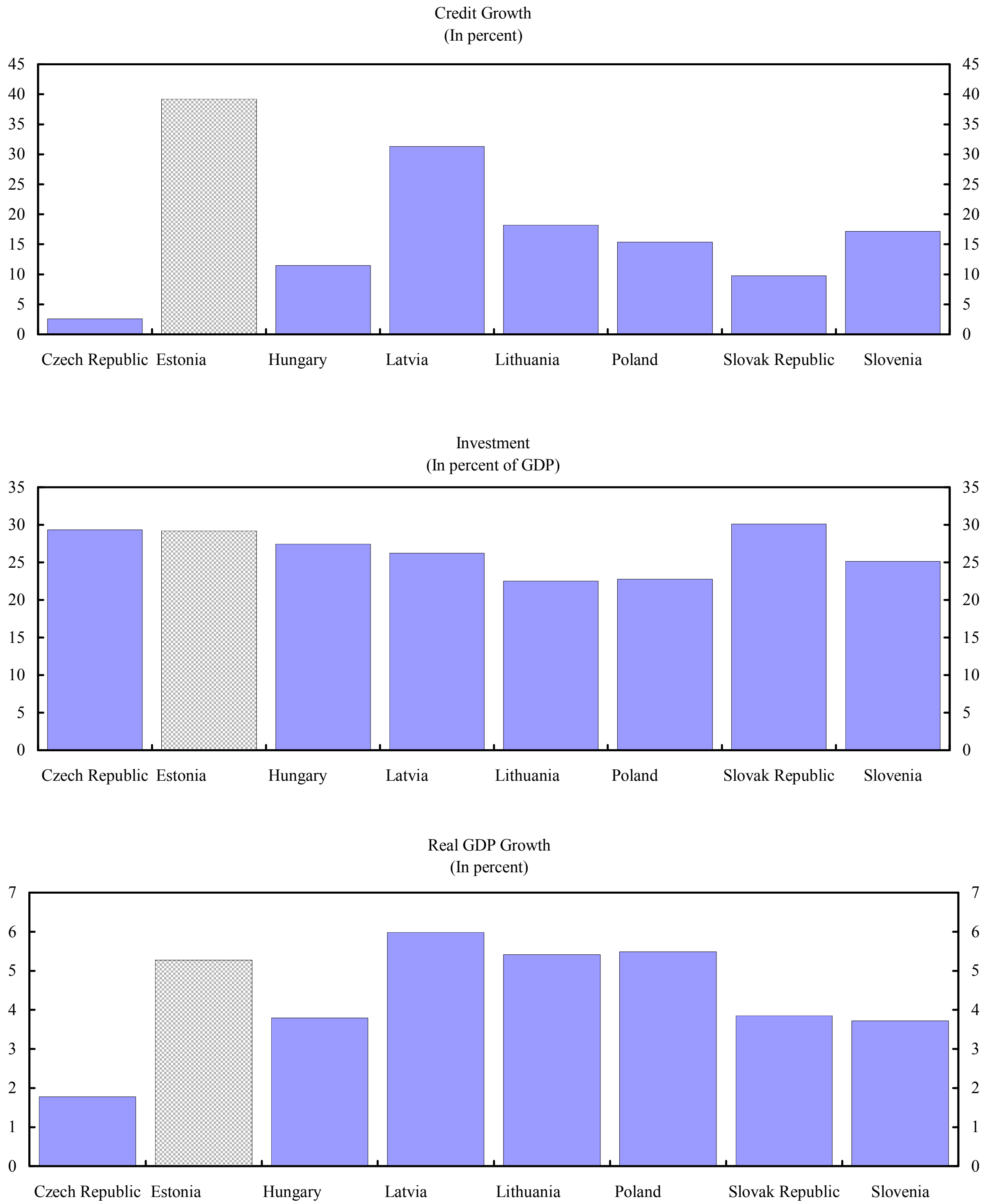
Figure 1. Estonia, New EU Members, and Euro Area: Selected Economic Indicators, 1996–2004



Sources: Country authorities; and Fund staff estimates.

1/ Unweighted average, excluding Estonia, Cyprus, and Malta.

Figure 2. New EU Members: Credit, Investment, and GDP Growth,1996–2003 Average



Sources: Country authorities; and Fund staff estimates.

Box 1. Estonia and the IMF

Estonia has had a remarkably successful relationship with the IMF since joining in May 1992.[1]

Type of Arrangement	Approval Date	Expiration or Cancellation Date	Amount Approved (SDR million)	Amount Drawn (SDR million)
Stand-by	9/16/1992	9/15/1993	27.9	27.9
STF	10/27/1993	N/A	11.6	11.6
Stand-by	10/27/1993	3/26/1995	11.6	11.6
STF	1/9/1995	N/A	11.6	11.6
Stand-by	4/11/1995	7/10/1996	14.0	-
Stand-by	7/29/1996	8/28/1997	14.0	-
Stand-by	12/17/1997	3/16/1999	16.1	-
Stand-by	3/1/2000	8/31/2001	29.3	-

Estonia's history with the Fund can be conveniently broken into four phases. The first, through 1993, was an initial period of macro stabilization. During this period the IMF provided policy advice, financing, and, importantly, technical assistance. At the time of independence, the Estonians were keen to have a market based economy as rapidly as possible and acquired technical assistance to this end, from the Fund and other sources. During this period, SDR62.7 million were drawn under Fund-supported programs.

The second phase started in 1994 and extended until the Russia crisis in mid-1998 and can be characterized as a period of recovery and growth. During this period the Fund continued to provide considerable technical assistance and policy advice, advice which was generally pursued. All of the financing was solely of a precautionary nature. The third phase focused on dealing with the fall-out of the 1998 Russian crisis and continued through 1999. Again, the principal contribution of the Fund was in providing policy advice and technical assistance; no drawings were made. The final phase can be characterized as recovery and the run-up to EU accession. During this period the Fund continued with policy advice and some technical assistance, but no financial arrangement. By the end of the period, Estonia was a surveillance country and a member of the EU.

Since the last consultation, the authorities have successfully managed the transition to ERM II entry. Directors' call for a more proactive fiscal policy to maintain macroeconomic stability was heeded in 2003, with an appreciable fiscal tightening, which is however set to be reversed in 2004.

In sum, Estonia's relation with the Fund has been characterized by a high degree of ownership of the implemented policies and has resulted in a successful transformation to a market economy. While there were differences (as in the Fund's initial advice against the setting up of a currency board), these were rapidly overcome and the cooperation focused on advancing reforms further. Finally, extensive use was made of technical assistance in all its forms.

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[1] The history of Estonia's relations with the IMF is more fully detailed in "The IMF and the Baltics: A decade of Cooperation," by Adalbert Knoebl and Richard Haas, IMF WP/03/241.

4. **Inflation accelerated in the first half of 2004, but is expected to remain within the Maastricht criterion**. Although rising fuel and sugar prices—reflecting EU tax harmonization—led to a spurt in year-on-year inflation to 4.5 percent in June 2004 (from 1.1 percent in December 2003), no lasting rise in inflationary pressures is foreseen—and indeed the 12-month rate receded to 3.9 percent in August. Economy-wide real wages increased substantially as a result of lower-than-anticipated inflation in 2003, but productivity gains dampened the effect on real unit labor costs, which increased only modestly.

5. **However, the external current account deficit deteriorated further and remains a cause of concern**. The current account deficit widened to 13.2 percent of GDP in 2003 (Figure 3). Part of the deterioration (approximately 4 percentage points of GDP) was due to “one-off” investments related to the renovation of Eesti Energia (Estonian Energy) and the modernization of Estonian railways, and is expected to unwind. Nevertheless, even accounting for the “one-off” investment, the underlying current account deficit was higher than its historical average.

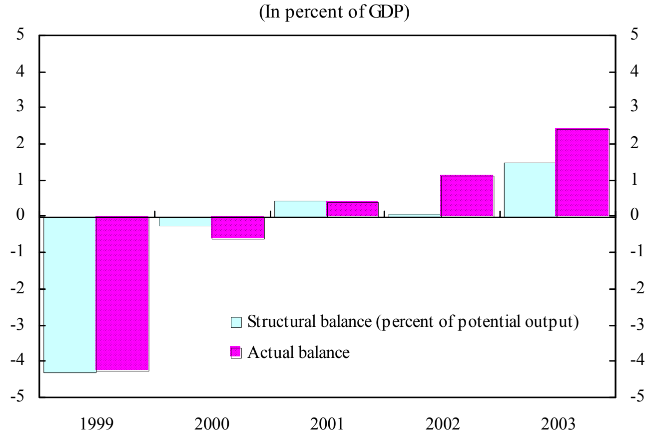
Measures of Core Current Account
(In percent of GDP)

	2002	2003	2004 Proj
Current Account	-10.2	-13.2	-11.2
Current account excluding "one-off" investment	-7.3	-8.3	-7.5
"One-off" imported investment (estimate)	-2.9	-4.9	-3.7
Primary Current Account /1	-7.3	-7.9	-6.4
Interest	-0.6	-0.5	-0.7
Reinvested earnings	-2.3	-4.7	-4.1

1/ Excluding interest payments and reinvested earnings.

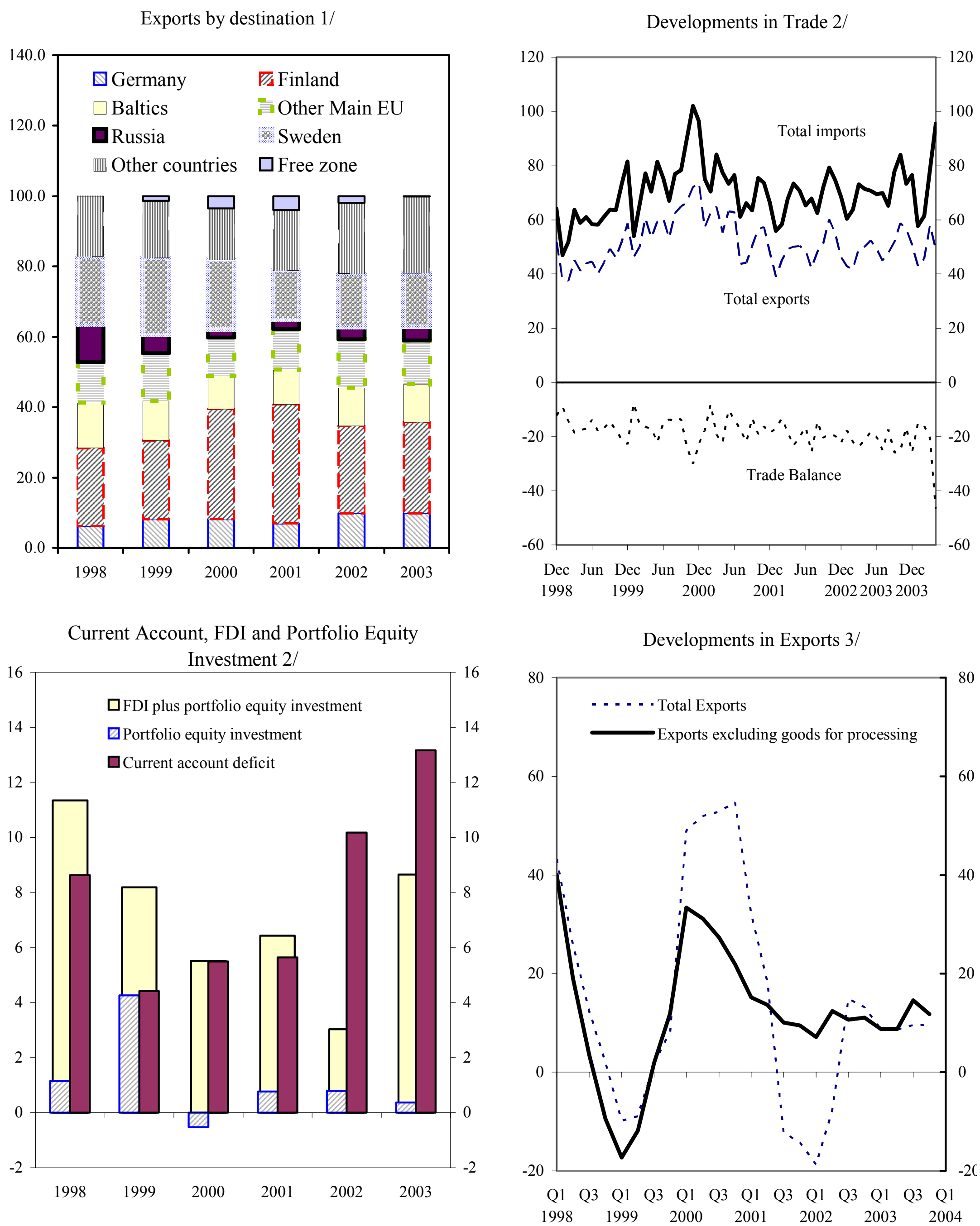
6. **Fiscal policy tightened in 2003**. The general government surplus more than doubled to 2.4 percent of GDP, with actual revenues exceeding forecast levels, reflecting, in part, stronger-than-expected domestic demand and employment growth. However, most of the fiscal tightening occurred as a result of postponed personnel and administrative expenditures of about 2 billion EEK (1.5 percent of GDP) and will be reversed in 2004.

Fiscal Developments in Estonia
(In percent of GDP)



7. **Domestic credit growth remained buoyant, financed increasingly by bank borrowing abroad, mainly from foreign parent banks**. Bank credit to households soared by around 50 percent at the end of 2004H1 over 2003H1, albeit from low levels (12.1 percent of GDP, and only 35 percent of household disposable income at the end of 2003, low by international standards), as households borrowed to acquire real estate. Nevertheless, real

Figure 3. External Sector Developments, 1998–2004



Sources: Bank of Estonia; and Fund staff estimates.
1/ Percent of total exports.
2/ In percent of GDP.
3/ Percent change over same period in preceding year.

estate prices rose only modestly in 2003 and remained stable in the first half of 2004. Credit growth to enterprises also accelerated to close to 30 percent (Figure 4). With a slowing in the growth of deposits, banks increasingly financed their lending from external sources, and the banking system's net foreign asset position turned negative in late 2003. While the banks have limited foreign exchange exposure, the foreign exchange positions of households and enterprises are high—around 65 percent of household loans and 78 percent of enterprise credits are in foreign exchange, 95 percent of which in euros.

8. **The largely foreign-owned banking system remains financially sound**. The risk weighted capital-adequacy ratio was around 15 percent in 2003 and the percentage of nonperforming loans declined further to 0.4 percent of the total—the lowest among transition countries—and the share of overdue loans in the export-oriented and real estate sectors was reduced in 2003. Although bank competition and declining interest rates squeezed margins and interest income declined, bank profits remained strong, with income from services fees growing briskly and Estonian banks expanding in neighboring markets.

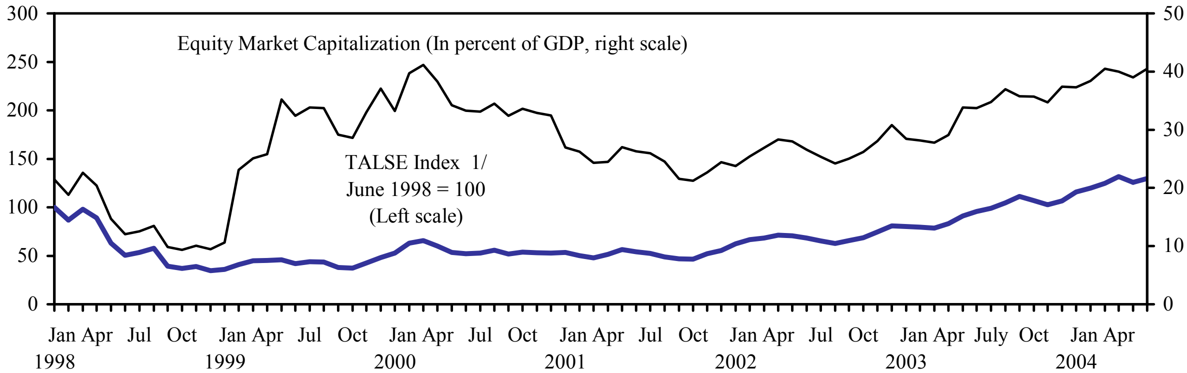
Banking Indicators, 1999-2004
(In percent, unless otherwise indicated)

	1999	2000	2001	2002	2003	2004 June
Capital Adequacy						
Capital adequacy—risk-weighted average	16.1	13.2	14.4	15.3	14.6	13.0
Liquidity						
Liquidity ratio	58.3	64.4	72.5	57.5	51.9	51.3
Total reserves/total deposits	28.1	25.4	14.5	14.4	16.6	15.5
Excess reserves/total reserves	43.3	19.0	16.7	1.5	1.5	1.1
Asset quality						
Nonperforming loans (in millions of domestic currency)	792.0	716.0	590.0	408.4	508.1	283.3
Loan-loss provisioning/gross loans	4.4	2.6	2.1	1.0	0.9	0.8
Loan-loss provisioning/nonperforming loans	118.3	81.4	91.7	123.3	106.7	102.1
Profitability						
Return on equity	9.2	8.4	20.9	12.4	12.5	14.2
Return on assets	1.5	1.2	2.7	1.6	1.5	1.6
Net interest margin	4.6	4.7	4.1	3.8	3.5	2.9
Loans and deposits						
Loans/deposits	100.9	98.5	95.3	102.4	109.3	133.8
Loans/total assets	56.6	59.2	59.5	61.2	64.7	69.0
Nonresident deposits as a share of total deposits	16.9	16.0	14.3	13.1	11.3	14.4
Nominal interest rate spread	4.5	3.9	5.4	3.7	3.5	2.9
Foreign currency deposits as a share of total deposits	31.1	34.0	30.1	28.7	26.4	28.7
Foreign currency loans as a share of total loans	76.1	77.9	78.7	82.6	81.9	80.2
Concentration						
C3	92.0	91.0	91.0	90.0	90.3	90.9
C5	99.0	99.0	99.0	99.1	99.4	99.4
Memorandum Items			(In percent of GDP)			
Total assets	28.7	33.5	48.0	75.6	80.2	95.7
Deposits (resident)	22.5	26.1	30.1	39.3	40.6	41.9

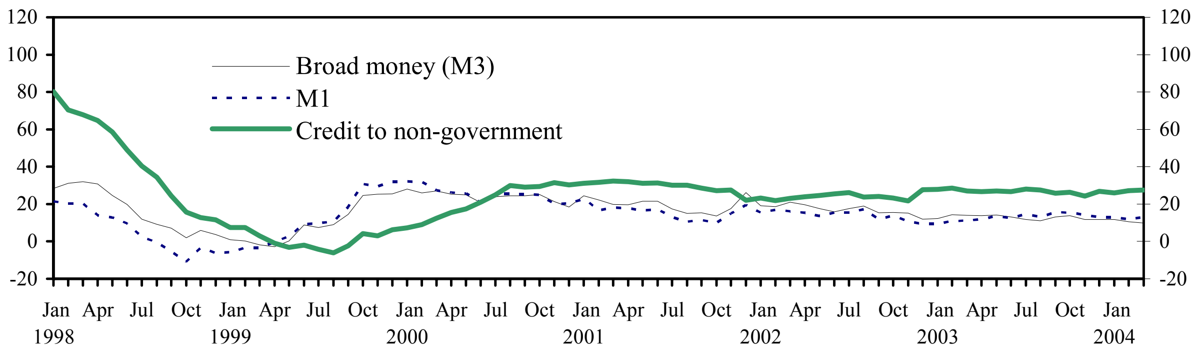
Source: Country authorities.

Figure 4. Estonia: Monetary and Financial Indicators, 1998–2004

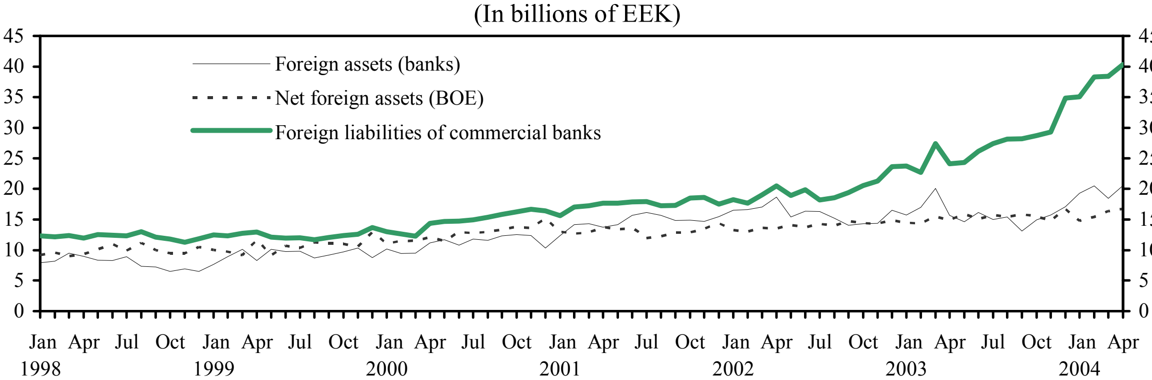
Stock Market Developments



Monetary Aggregates
(Twelve month growth rate in percent)



Foreign Assets and Liabilities
(In billions of EEK)



Sources: Bank of Estonia; Statistical Office of Estonia, IFS, and Fund staff estimates.
1/ Tallinn Stock Exchange index.

9. **Despite increased external vulnerabilities, confidence in the currency board arrangement remains strong**. Indeed, in line with Estonia's early ERM II participation, no currency risk is currently priced in domestic assets, with Standard & Poors' (S&P) sovereign foreign and domestic currency ratings being equal. Estonia's credit rating was upgraded in July 2004 by Fitch to A from A- following upgrades by both Moody's and S&P in 2002; Estonia's Eurobond spread over German bunds declined further to less than 5 basis points at the end of second quarter of 2004. Reserve coverage of base money has remained stable.

III. Report on the Discussions

10. **The discussions focused on the policy priorities required for successful performance in ERM II and the subsequent smooth adoption of the euro**. In particular, the discussions centered on: (i) the near to medium-term outlook and associated risks, with particular focus on external vulnerabilities; (ii) the viability of the ERM II central parity rate and monetary and financial policies in the run-up to euro adoption; (iii) the appropriate fiscal stance during ERM II participation.

11. **The authorities reiterated their intention to participate in ERM II at the current euro rate as soon as possible while unilaterally maintaining the currency board**. The Bank of Estonia (BoE) argued that, given the well-established credibility of the currency board over the last 12 years, this would eliminate the need for a double-regime switch and facilitate the smooth adoption of the euro. At the same time, BoE emphasized the importance of fiscal policy in the context of the currency board in restraining domestic demand, curbing inflationary pressures, and reducing external vulnerabilities. Staff concurred and added that the credibility and consistency of macroeconomic and structural policies would be crucial in keeping the Estonian economy competitive. It also noted the government's important signaling effect on the economy in determining public sector wage increases and the consequent need for moderation.

A. Near and Medium-Term Outlook

12. **There was a consensus that the macroeconomic outlook for 2004 and over the medium-term remains favorable**. In their 2004 convergence program, the authorities project real GDP growth of close to 6 percent over the medium term and a current account deficit which declines gradually from 13 percent of GDP in 2004 to 8.7 percent in

2004 Convergence Program: Selected Indicators, 2003-2008

(In units as indicated)

	2003	2004	2005	2006	2007	2008
		Proj.				
Real GDP (growth, in percent)	4.7	5.3	5.8	5.6	5.9	5.8
Private consumption	6.2	6.2	6.0	6.3	5.4	5.3
General government consumption	5.6	6.5	3.9	3.6	3.3	3.1
Gross fixed capital formation	11.5	6.7	9.1	7.8	7.7	7.7
Exports	6.0	7.4	8.5	9.9	9.3	9.3
Imports	9.0	7.2	7.9	8.9	8.7	8.5
Average CPI inflation, (year-on-year, in percent)	1.3	3.1	3.0	2.8	2.8	2.8
Unemployment rate, (in percent)	10.0	10.0	9.4	9.5	9.4	9.4
Fiscal Balance, (in percent of GDP)	2.6	0.7	0.0	0.0	0.0	0.0
Current Account Balance, (in percent of GDP)	-13.7	-13.0	-11.4	-10.8	-9.6	-8.7

Sources: Estonian authorities, May, 2004.

2008, both slightly higher then staff projections. The staff projects real GDP to grow by 5¾ percent in 2004, dropping to 5 percent in 2008, driven by both strong domestic and external demand. Staff projects the current account deficit to decline to around 6 percent of GDP from a forecast of 11.2 percent in 2004, as "one-off" investment projects are completed and as private savings, supported by growing participation of the second and third pillars of the pension system, increase. Both the authorities and the staff forecast average inflation to rise to about 3 percent in 2004, from 1.3 percent in 2003, as a result of EU tax harmonization and an increase in administered prices. However both staff and official forecasts are not without risks. In particular, on the domestic side, private savings might not rebound as expected, with repercussions on the external account; on the external front, further oil price increases and weaker export markets are key downside risks.

13. **In view of these downside risks and of Estonia's relatively high gross external debt, staff presented two scenarios for the path of gross external debt ratio over the medium-term—a baseline scenario and a worse-case scenario**.[1, 2] In the baseline scenario, gross external debt, almost all of which is private, was 70.5 percent of GDP in 2003 and is projected to decline to 65 percent of GDP in 2009. For most of the standard shocks under the Fund's external sustainability exercise, external debt stabilizes at below 80 percent of GDP in 2009 (Table 8). In the worse-case scenario, which could occur if FDI coverage of the current account is substantially less than the 50 percent assumed in the baseline, gross external debt increases from 70.5 percent in 2003 to around 80 percent of GDP in 2009; the application of the standard interest rate shock results in a faster accumulation of gross external debt, reaching nearly 90 percent of GDP in 2009 (Table 8a). However, the authorities responded that, due to transition, the ten-year average historical shocks used in these scenarios overstate the magnitude of possible shocks in the future and the likelihood of shocks of this magnitude was consequently seen to be small.

14. **Against this background, staff highlighted the external vulnerability risks posed by continuing high current account deficits**. While previous studies[3] have found that a significant part of the variation in the current account deficits in the Baltic countries is explained by productivity-improving investments and consumption-smoothing, staff emphasized that the present level of the current account deficit is not sustainable in the long-term.

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[1] Public sector debt does not pose any sustainability risks due to its very low level of about 4 percent of GDP. Therefore, staff discussed only external sustainability issues.

[2] It should be noted that Estonia's net external debt was only 22.8 percent of GDP in 2003, and has increased by less than gross debt in recent years, because the economy's gross foreign assets have risen, reflecting increased economic and financial integration.

[3] See IMF Country Report 03/331 and ECB Working Paper No. 311, February 2004.

15. **The authorities recognized the risks of increased external vulnerability, but pointed out several offsetting factors**. They noted that the level of the primary current account deficit, excluding interest payments and reinvested earnings (the latter of which are self-financing) was in line with estimated equilibrium levels of the current account deficit over the medium-term. Moreover, they pointed out that, on average, 70 percent of the current account deficit was financed by FDI[4] during 1996–2003, with the bulk of FDI going to manufacturing and financial sectors, while net external debt increased only modestly and remains relatively low. In addition, the authorities noted that investment had grown strongly and had resulted in substantial productivity improvements, placing Estonia among the fastest growing new EU members. The strong productivity growth has also supported exports and resulted in a substantial increase of Estonia's export share in its main trading partners (Box 2).

B. Viability of the Current ERM II Central Parity

16. **The authorities and staff agreed that the current ERM II central parity rate is viable in the run-up to the euro adoption**. Estonia joined ERM II at the end of June 2004 with a commitment to unilaterally maintain the currency board. In light of the high degree of nominal convergence, the track record of a successful currency board over the last 12 years, and current views and expectations of Estonia's competitiveness, staff supported this decision. Although there is, unavoidably, some uncertainty around estimates of the equilibrium real effective exchange rate, staff agreed with the authorities that the present level of the EEK/euro peg falls within the estimated range of the equilibrium rate and no major competitiveness pressures are evident. Staff stressed, however, that external competitiveness would be maintained only if wage increases reflected improvements in productivity over the medium term.

17. **However, continuing high current account deficits and credit growth, combined with low domestic saving, suggest a nascent overheating and pose potential risks for Estonia in the period ahead**. These risks could translate into the potential cost of having to adjust in the future to entry in ERM II at an overvalued real effective exchange rate. The authorities noted, however, that the labor market in Estonia is quite flexible and, therefore, output losses would be expected to be both temporary and small. While staff agreed that Estonian labor market is flexible and noted that recent studies[5] of international institutions (the OECD, EC and ECB) also supported this view, it emphasized that labor market

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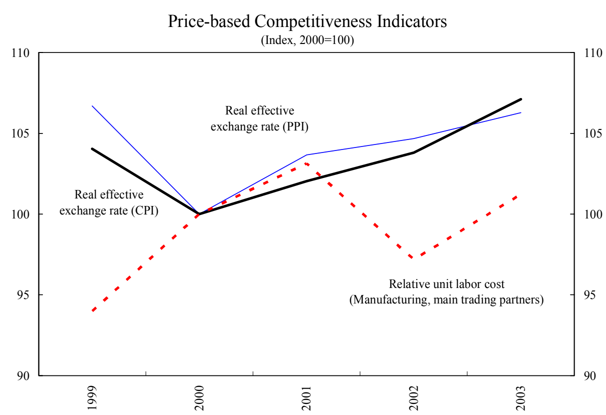
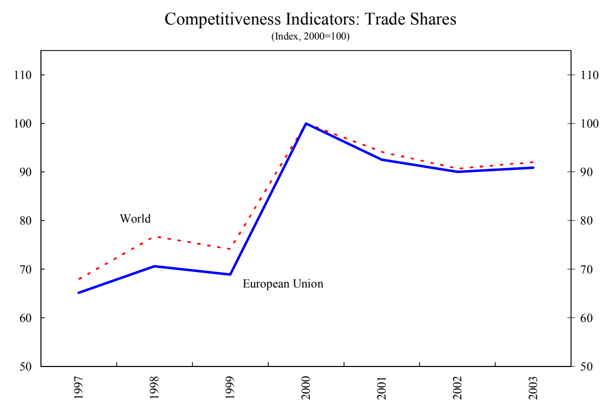
[4] This topic is dealt with in more detail in the Selected Issues Paper, "Estonia's External Debt and Domestic Balance Sheet Developments."

[5] The studies characterized the Estonian labor market as flexible, noting the predominance of enterprise-level bargaining, the low rate of unionization, a low minimum relative to the average wage, a modest unemployment compensation replacement rate, and a high degree of wage flexibility.

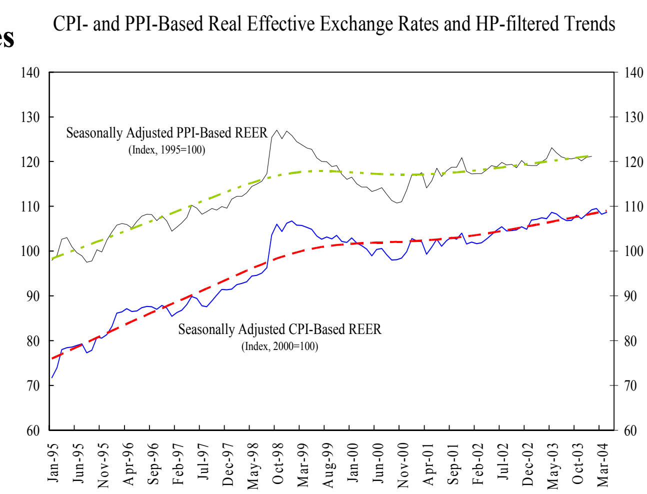
Box 2. Indicators of Competitiveness and Equilibrium Exchange Rate

Estonia's external competitiveness remains relatively strong. Both PPI-based and CPI-based real effective exchange rates have appreciated by around 2 percent annually since 2000, consistent with a Balassa-Samuelson effect of the same magnitude. In addition, unit labor costs in manufacturing relative to Estonia's trading partners have remained broadly unchanged over the last three years, as wage increases were matched by strong productivity growth. Market shares of Estonian exports in both world and EU imports increased significantly over the last decade with a recent pause related to the mobile telephones market. Thus, despite the large current account deficit, there is no clear evidence of a competitiveness problem.





The actual real effective exchange rate is within the range given by different estimates of the equilibrium real exchange rate. For example, IMF Country Report No. 03/114, found that the actual real effective exchange rate in Estonia was around 8 percent below its equilibrium level in mid-2002 (the year when the current account deficit doubled from its 2001 level of 6 percent). Randveer and Rell ("The Relationship between Competitiveness and Real Exchange Rate in Estonia," BoE Research Paper) also found that the real effective exchange rate was roughly in line with the equilibrium rate. In addition, both the PPI-based and CPI-based real effective exchange rates have been broadly in line with Hodrick Prescott-filtered trend levels since the beginning of 2001.



flexibility needed to be maintained in the future to avoid the disruptive effects on the economy of negative exogenous shocks.[6]

C. ERM II Membership and Supporting Monetary and Financial Policies

18. **The discussions focused on the main policies needed for supporting smooth ERM II participation and the consequent adoption of the euro**. In addition to prudent fiscal policies, the discussions centered around high credit growth to households and the available policy responses, banking supervision, and the activities of Kredex—a quasi-government loan guarantee agency.

19. **The authorities emphasized that levels of bank credit in Estonia are not excessive when compared to the other new EU members**. The BoE had recently undertaken a comparative study of credit developments in the new EU members and the results suggested that Estonia's domestic credit level is below the average for the sample, although the growth rate is among the highest. Staff stressed that although rapid credit growth has been experienced in other transition and peripheral euro area members, and is an expected feature of real convergence, it posed potential risks to macroeconomic and financial stability and needed to be monitored carefully. The authorities agreed and pointed out that they had recently reduced borrowing incentives by limiting mortgage interest deductibility. In addition, they also noted that the BoE and the Financial Supervisory Authority (FSA) had repeatedly drawn Estonian banks' attention to the need for conservative lending practices.

20. **Nevertheless, the authorities were aware of the risks that fast credit growth poses to macroeconomic stability and had considered, but rejected, several options to moderate credit growth, aside from continuing moral suasion**. The FSA also noted that many banks followed credit scoring and internal risk management strategies consistent with prudential regulations applied at the parent foreign banks. The authorities found staff's suggestion to introduce statistical provisioning[7] appealing, but they pointed out that, because Estonia has not yet experienced a full economic cycle, it would be difficult to estimate the amount of provisioning. In responding to staff's proposal to tighten prudential controls, the BoE noted that, while it would continue to monitor credit growth closely, it was reluctant to use prudential requirements to restrict it. The authorities also emphasized that tightening of prudential regulations should be applied carefully, because this might create incentives for changing the structure of the Estonian banking system from subsidiaries to branches, as capital adequacy requirements do not apply to branches.

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[6] On the importance of labor and product market flexibility for reducing Estonia's vulnerability to adverse external shocks, see the Selected Issues Paper, "Estonia: Labor and Product Market Flexibility and Productivity Catch-up in the Run-up to the Euro Adoption."

[7] Statistical provisioning accounts for the phase of the economic cycle in calculating loan loss provisions and reduces their procyclical behavior.

21. **As a measure to reduce credit growth, the authorities planned to further reduce mortgage interest deductibility**. The government intends to decrease total deductions from taxable income to 50 thousand EEK starting in January 2005. The BoE was also aware of the impact of Kredex on mortgage loan growth, given its large share (around 20 percent of all mortgages). While recognizing the benefits of a slower pace of growth of its activities, it noted the sensitive social and political implications of limiting Kredex activities. Staff supported the reduction of mortgage interest deductibility and recommended that the authorities carefully assess the macroeconomic implications of Kredex operations. In particular, staff suggested that they take into account the impact on credit growth and macroeconomic imbalances when considering future increases in either the overall or individual limits on guarantees issued.

22. **The authorities described the results of stress tests, in particular, of bank vulnerability to interest rate shocks**. They pointed out that banks perform interest rate stress tests on a quarterly basis, using the methodology of the parent banks. At the same time, to ensure compliance with Estonia's supervisory regulations, the FSA also gathers data and replicates the interest rate stress tests. The authorities also explained that the banks had been instructed to educate borrowers about the implications of rising future interest rates for servicing variable rate mortgages. FSA noted that due to the high credibility of the currency board and the relatively mild fall-out from the Asian and Russian crises, exchange rate stress tests had not been performed. However, it emphasized that, although domestic foreign currency denominated borrowers could pose credit risks, the banks had a positive net foreign exchange exposure and were well-capitalized and provisioned against possible exchange rate shocks.

23. **The authorities have no plans to issue a 10-year maturity domestic currency denominated bond in the near future**. While they agreed with staff that such an instrument would likely promote growth of the domestic bond market by providing a benchmark interest rate and promote long-term investment vehicles for the rapidly growing second pillar pension funds, they noted that because of the government's strong financial position there is no real need for such an instrument at present.

D. Fiscal and Public Sector Issues

24. **The authorities planned for a balanced budget in 2004, but a better outcome seems likely**. They explained that budget developments in the first half of the year suggest a fiscal surplus of about ¾ of a percent of GDP, as better than projected revenues more than offset postponed expenditures in 2003. The revenue impact of EU-related VAT changes was expected to be roughly neutral, as measures having a negative impact on revenues (e.g., the one-off loss due to VAT taxation deferment) are compensated by measures having a positive impact (fuel and tobacco excises increase and the abolition of VAT incentives on goods received as foreign aid). The authorities also noted that, although there were some delays in the disbursement of EU funds, no budgetary pressure from these delays is expected, and they expressed satisfaction with the utilization of agricultural and entrepreneurship funds from the EU. Staff, while agreeing on the likelihood of a better-than-budgeted outcome, noted that it

would still fall well short of the recommendation to maintain a surplus similar in magnitude to that achieved in 2003, imparting an untimely fiscal stimulus to the economy.

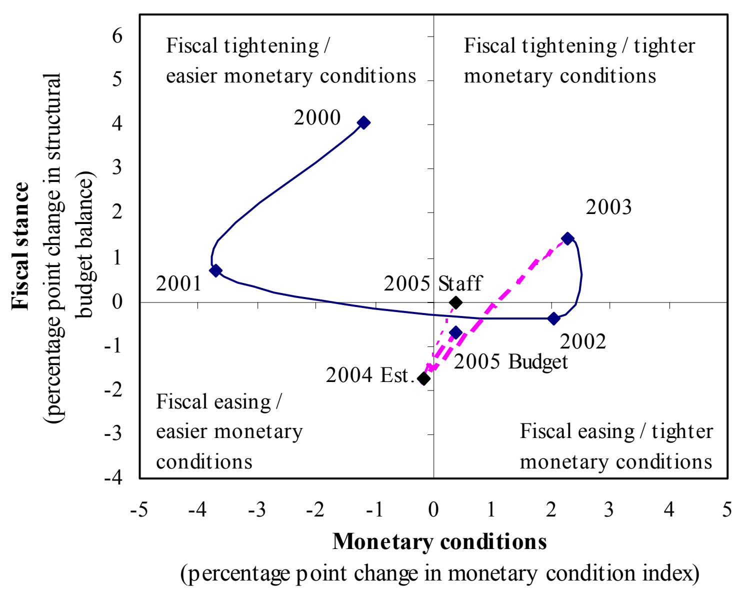
Expected Impact of Tax Policy Changes on the 2004 Budget

Change	Introduction	Effect on State Budget Revenue
Deferment of the moment of taxation: VAT on intra-EU acquisitions is declared on the VAT return of the tax period, instead of being paid at the border when goods are brought into Estonia.	May 1, 2004	Decreases *ca* 700 million EEK
Abolition of tax-free trading in shipping and aviation on trips within the EU.	May 1, 2004	Increase *ca* 180.0 million EEK
Abolition of VAT incentives on goods received as foreign aid and on goods and services for foreign loan or for money received as foreign aid.	May 1, 2004	Increase *ca* 400.0 million EEK
On hire-purchase (finance lease) VAT is paid at the transfer of goods on whole consideration instead of former VAT paid on lease payments.	May 1, 2004	Increase *ca* 400.0 million EEK
Cigarettes excise 210 EEK/1,000 cigarettes + 24% increases to 240 EEK/1,000 cigarettes + 25% (tobacco excise).	July 1, 2004	Increase *ca* 80 million EEK

Source: Estonian authorities.

25. **The authorities have targeted a balanced budget in 2005 as well as over the medium term**. The main goal of the 2005–08 budget strategy was to keep balanced—or slightly positive—budgets over the medium term. In view of the planned income tax cuts, the authorities noted that to achieve the goal of balanced budgets, as a first step, they would need to increase indirect taxes (primarily on cigarettes and alcohol). In addition, as a supporting measure, they might consider possible expenditure cuts, but, at this stage, these were difficult to identify. Staff suggested that further rationalizing the large number of local government units would provide some relief to the budget and help accommodate the tax decrease.

Macroeconomic Policy Environment in Estonia



26. **Staff stressed that, absent an independent monetary policy, a restrictive fiscal policy in 2005 was needed to limit external vulnerabilities**. It noted that, given the expected surplus in 2004, the 2005 budget target of an overall balance for the general government would imply an appreciable easing of fiscal policy—about ¾ of a percentage

point of GDP. Staff reasoned that, despite Estonia's enviable government debt position, for reasons of external balance and likely long-run pressures related to increasing pension and health care costs, the authorities should save the entire 2004 fiscal surplus and target, at a minimum, a neutral fiscal stance in 2005. A neutral fiscal stance would imply raising the 2005 target from a balanced budget to a surplus of at least ¾ percent of GDP. The authorities agreed, in principle, that, because of increased external vulnerabilities, a fiscal surplus in 2005 similar in magnitude to the one expected in 2004 would be desirable. However, they noted that it would require large expenditure cuts, which they saw difficult to achieve.

27. **Staff argued that, fiscal surpluses should be reduced only gradually over the next several years, with implications for the government's planned tax reductions**. The government intends to lower the level of taxation and to reduce the size of the public sector by the end 2007. The coalition agreed in December 2003 to lower the flat rate personal income tax rate from the current 26 percent to 20 percent over the next three years, while increasing the nontaxable threshold to 1,700 EEK in 2005 and 2,000 EEK in 2007. Staff emphasized, however, that to reduce external vulnerabilities and ensure a smooth adoption of the euro, taxes should be reduced only after expenditure cuts have been clearly identified, unwinding the fiscal surplus only gradually.

28. **The Estonian pension reform has been a success, but staff saw potential pressures on the PAYG first pillar in the future**. With more than half of the eligible working population participating in the fully-funded second pillar by the end of 2003, interest in it has far exceeded initial expectations. And the Ministry of Finance (MoF) projected a sustainable pension fund in the long-run, assuming the current pension indexation formula. Staff, however, pointed that under the MoF's assumptions, replacement rates declined substantially (from around 40 percent in 2003 to about 29 percent in 2020). This fall in the replacement rate, together with a declining and aging population, and the costs associated with the shifting of contributions to the second pillar, could put pressure on the first pillar and lead to increasingly larger deficits in the coming years (Box 3).

29. **There was a broad agreement that healthcare spending was likely to increase substantially in the medium-term for both demand and supply reasons**. The authorities noted that surveys among health care personnel suggested that a fair number had considered accepting jobs abroad. To keep these people in Estonia, higher wages would be needed, which would result in supply pressures to the health insurance fund. In addition, as living standards improved and life expectancy increased, growing demands of an aging population, especially for long-term care, would weigh on health care costs.

Box 3. Aging and Healthcare Expenditures Over the Long Term

While under current policies the pay-as-you-go (PAYG) first pillar is sustainable, the average replacement rate declines significantly and could lead to pressures for higher pensions in the future. In the 2004 convergence program, the authorities project a positive balance for the first pillar and growing reserves for the PAYG first pillar. However, the real GDP growth and returns on the second pillar assets assumed in the simulations (both around 5 percent through 2020) seem overly optimistic. And the average (first plus second pillar) replacement rate declines by more than 10 percentage points by 2020.

Long-term sustainability of pensions and healthcare funds

	2000	2005	2010	2020	2030
Pensions					
2004 Convergence program					
Average replacement rate 1/	39.9	36.9	34.1	28.6	28.9
Balance of PAYG, percent of GDP	0.1	-0.4	-0.1	0.7	1.2
PAYG reserve, percent of GDP	0.0	0.6	-1.0	3.0	9.9
Alternative scenario					
Average replacement rate 1/	39.9	38.1	39.5	39.2	38.0
Balance of PAYG, percent of GDP	0.1	-0.3	-0.3	-0.6	-1.2
PAYG reserve, percent of GDP	0.0	-1.3	-2.8	-4.6	-14.8
Healthcare					
Healthcare contributions, in percent of GDP	4.8	4.5	4.0	3.3	3.1
EU average health and long-term care, in percent of GDP 2/	6.6				
increase in expenditures between 2000 and 2050, per capita	2.2				
increase in expenditures between 2000 and 2050, per worker	2.7				

1/ Net average pension (first and second pillars) over net average wage, in percent.
2/ 2001 EU report on "Budgetary challenges posed by ageing populations".

An alternative scenario, assuming constant average replacement rates and lower real GDP growth and returns on second pillar assets, results in permanent deficits of the PAYG first pillar and growing liabilities. Under this scenario, the average annual deficit of the PAYG first pillar is around ½ percent of GDP, and the system accumulates significant liabilities—15 percent of GDP by 2030, in contrast to a 10 percent surplus in the authorities' baseline.

Projected healthcare expenditures also seem to be underestimated in the baseline scenario. Several reasons could lead to higher than expected healthcare expenditures. First, as life expectancy increases, healthcare costs are expected to rise. As the 2001 EU study on ageing population concludes, healthcare expenditures in the EU countries could rise by close to 3 percent of GDP by 2050. Second, as anecdotal evidence shows, some healthcare workers consider accepting higher paid jobs in the richer EU countries, which suggests that with rising incomes, there could be competitive pressures for higher payments to healthcare workers.

30. **The authorities expressed their satisfaction with the December 2003 FAD mission on multi-year budgeting and noted that the main recommendations of the mission have been implemented**. Multi-year budgeting was implemented and the authorities expected more efficient fiscal planning.

31. **There were differences in views between MoF and local governments about the proposed new local governments act**, expected to be submitted to Parliament in the autumn. While the MoF's viewpoint was that the law would strengthen local governments' financial discipline and increase their efficiency, local governments disagreed and complained about increased mandates without commensurate increase in resources. Local governments noted also that the new revenue distribution formula (11.4 percent of the total tax base) significantly worsened their revenue collection compared to the old formula (56 percent of revenue collections), and created budgetary tensions. Staff pointed that it stood ready to provide technical assistance in state and local financial relations if the authorities thought it useful.

32. **EU accession could have significant budgetary implications**. EU transfers may result in lower revenue due to a combination of factors such as co-financing obligations, Schengen border-related expenses, loss of customs revenues from imports originating in the EU, and a decrease in VAT receipts as a result of the elimination of border customs controls. Even with conservative estimates for the efficiency loss of VAT collections after EU accession, the estimated net negative impact of EU disbursements on the budget could be around ¾ percent of GDP by 2006 (Table 10), highlighting the need for tight expenditure control.

Fiscal Impact of EU Accession, 2004-06.
(In percent of GDP)

	2004	2005	2006
Estimated disbursements from EU	**3.9**	**3.6**	**4.2**
Net estimated disbursements from EU	**3.2**	**2.5**	**3.1**
Impact of EU disbursements on:			
Consolidated budget revenue	4.6	4.2	4.8
Consolidated budget expenditures	-4.2	-4.4	-5.2
Consolidated budget co-financing	-0.7	-0.7	-1.1
Consolidated budget savings and substitution in expenditures	0.2	0.5	0.7
Net impact on the consolidated budget	**-0.1**	**-0.4**	**-0.8**

Source: Ministry of Finance and Fund staff estimates.

E. Structural Policies

33. **The pace of structural reform slowed, as most large scale privatizations were completed**. The authorities have no intention to sell the government's stake in Estonian Air (34 percent) in the near future. While a privatization offer was, in principle, considered for the government's "golden share" in the Estonian telecom (27.3 percent), a deal is not expected in the near term. Progress continues in adopting the EU's *acquis communautaire*; this could involve some structural regression in Estonia's open trade system, notably in agriculture.

34. **The restructuring of the energy sector has advanced as planned**. The authorities have refurbished two of the blocks of Eesti Energia on schedule. They intend to link the electric grid with Finland and make it operational by 2006. In line with EU accession

agreements, the authorities intend to gradually liberalize the energy market to 35 percent by the end of 2008, from the current 10 percent, and fully open it by the end of 2012. The authorities also plan to reduce the economy's dependence on oil shale by the introduction of wind- and wood-based production capacities, which are expected to generate 5 percent of the energy needs by 2010.

35. **The authorities discussed the possibility for creating a venture capital fund to support the development of the information technology sector**. The authorities explained that the size of the fund is intended to be relatively small (0.5 billion EEK) with 50 percent private participation. While recognizing Estonia's strong record of transparency, staff stressed that global experience with such schemes indicates less than stellar outcomes and, therefore, felt that a more market-based solution would be preferable.

36. **Active labor market policies designed to reduce unemployment will be submitted to Parliament in the autumn**. The authorities noted that, despite Estonia's generally flexible labor market, certain features could be further improved. In particular, they plan to replace the unemployment benefits with a jobseeker's allowance, which is intended to induce the unemployed to actively search for jobs. The authorities pointed that although the unemployment rate has declined in recent years, it remains a persistent problem in some regions and among those with low skills. There are still severe skills mismatches and a large number of long-term unemployed, especially among non-Estonian speakers in the depressed northeast. To deal with these issues, the authorities plan to improve the current system of vocational training by better targeting the needed groups. Staff welcomed these initiatives.

F. Other Issues

37. **The authorities have implemented legislation to combat money laundering and the financing of terrorism**. Estonia's anti-money laundering legislation has been brought in line with the latest EU directives in this area. The methods used by the Financial Intelligence Unit seem to work effectively, as reflected in the increased number of cases judged to be suspicious in 2003 versus 2002. Estonia has fully implemented all U.N. Security Council Resolutions regarding the financing of terrorism.

38. **Estonia has been at the forefront of transparency and provides good quality data**. They subscribed to the SDDS in September 1998 and started posting metadata in January 1999. Estonia is in observance of the SDDS and meets the specification for coverage, periodicity, and timeliness of the data dimension for most data categories, with the exception of timeliness of quarterly GDP, for which a flexibility option is being taken.

IV. Staff Appraisal

39. **Estonia's remarkable economic transition and solid economic performance culminated in EU membership on May 1, 2004.** The country joined ERM II and is in compliance with the Maastricht criteria, with all convergence indicators at better levels than those in the other new EU members. The economy is well poised to meet the challenges in the transition to the euro.

40. **However, the current account deficit remains high and is a potential cause of concern**. Not because it signals a loss in competitiveness—conventional measures of competitiveness indicate that this is not a problem in Estonia—but because it indicates growing tensions that are not sustainable over the medium term if left unaddressed.

41. **Estonia's currency board arrangement underlines the need for an especially conservative fiscal policy to minimize risks under ERM II**. The currency board is a viable strategy in the run-up to euro adoption. Estonia's credit rating is relatively high and there appear to be no problems of competitiveness. No currency risk is currently priced in domestic securities, attesting to the system's credibility. However, macroeconomic and structural policies will need to be carefully directed at underpinning such credibility and maintaining Estonia's competitiveness. Under a currency board arrangement, fiscal policy must play the dominant role in restraining domestic demand and curbing inflationary pressures.

42. **In the present context, this means running a surplus in 2005 at least similar to that expected in 2004, decreasing gradually to balance over the medium term so as to avoid a large, unwelcome fiscal stimulus**. Such an approach, combined with favorable external demand and an expected increase in private savings, will help to avoid overheating the economy, restore the current account balance to more sustainable levels, and reduce external vulnerabilities.

43. **The authorities plan to reduce income tax rates over 2005−07, but this would require identifying offsetting savings**. The above objective of fiscal restraint must have primacy and taxes should only be reduced if realistic expenditure cuts (or other revenue sources) have been clearly identified. Further rationalizing the large number of local government units could provide some relief to the budget that would help accommodate the tax decrease and, also, enhance efficiency in the public sector. Improving intergovernmental finances could also provide efficiency gains.

44. **The authorities have to address the needs of an aging population while ensuring long-term fiscal sustainability.** Although, from a fiscal standpoint, Estonia is better placed than many countries, the costs of an aging population and increasing health care are expected to put pressure on the budget in the long term. The fiscal surpluses now required for macro stability provide an opportunity for the country to provision for the future needs of Estonians. Accordingly, the 2004 and subsequent fiscal surplus should be set aside to finance the future needs of the first pillar of the pension system. The recent adoption of a multi-year budgeting program is a welcome step in achieving this goal.

45. **Credit growth should continue to be monitored carefully and active consideration given to tightening prudential controls if needed.** In light of Estonia's strong economic growth record, and the relatively mild collateral damage in the wake of the Asian and Russian crises, there is a distinct possibility that risks of future downturns could be underestimated by borrowers and lenders alike. Thus, an emerging "financial accelerator" could contribute, in the absence of vigilant financial sector supervision, to increasing the amplitude of the business cycle.

46. **In addition to prudent fiscal budgeting, the need for a flexible labor market remains paramount in supporting the currency board**. External competitiveness will be maintained only if wage increases reflect, over the medium term, improvements in productivity. While most wage agreements are conducted at the firm level, taking into account specific developments, the government must remain aware of the signaling role that it provides in determining public sector wages. The authorities' intention to focus efforts on integrating youth and the long-term unemployed into the ranks of wage earners through the use of active labor market policies is also welcome.

47. Staff recommends that the next Article IV consultation with Estonia be held on the standard 12-month cycle.

Table 1. Estonia: Selected Macroeconomic Indicators, 1999–2005
(In units as indicated)

	1999	2000	2001	2002	2003	2004 Proj.	2005 Proj.
National income, prices and wages							
Nominal GDP (kroons, millions)	81,640	92,717	104,338	116,869	125,832	138,162	150,367
GDP (euro, millions)	5,218	5,926	6,668	7,469	8,042	8,830	9,610
Real GDP growth (year-on-year in percent)	-0.1	7.8	6.4	7.2	5.1	5.8	5.4
Average CPI (year-on-year change in percent)	3.3	4.0	5.8	3.6	1.3	3.0	2.5
12-month CPI (end of period change in percent)	3.9	5.1	4.2	2.7	1.1	4.4	1.2
GDP deflator (year-on-year change in percent)	4.5	6.7	5.2	4.4	2.4	3.8	3.3
Average monthly wage (end-of-period, euro)	284	312	352	390	428	450	472
Unemployment rate (ILO definition, percent)	12.2	13.7	12.6	10.3	10.0	8.1	7.3
Saving-investment balances (in percent of GDP)							
Domestic saving	20.5	22.4	23.6	21.6	18.0	19.7	20.6
Private	20.7	20.0	20.1	16.9	12.5	14.4	16.3
Public	-0.2	2.3	3.4	4.7	5.5	5.2	4.3
Domestic investment	25.0	27.9	29.2	31.8	31.1	30.9	30.1
Private	20.8	24.9	26.2	28.2	28.1	26.4	26.0
Public	4.1	3.0	3.0	3.6	3.1	4.5	4.1
Foreign saving	4.4	5.5	5.6	10.2	13.2	11.2	9.5
General government (in percent of GDP)							
Revenue and grants	36.4	35.7	35.4	36.6	38.5	39.8	38.5
Expenditure and net lending	40.6	36.3	35.0	35.5	36.0	39.0	38.3
Fiscal balance	-4.3	-0.6	0.4	1.1	2.4	0.8	0.2
External sector (euro, millions)							
Trade balance	-773	-840	-881	-1150	-1397	-1477	-1500
Service balance	533	612	649	618	751	833	934
Current account	-231	-326	-376	-759	-1059	-991	-915
Gross international reserves (euro, millions) 1/	852	992	930	958	1107	1139	1201
in months of imports	3.3	2.7	2.4	2.4	2.4	2.3	2.2
Relative to gross short-term debt (including trade credits)	0.9	0.8	0.7	0.6	0.6	0.6	0.5
Gross external debt/GDP (in percent) 2/ 3/	58.7	54.7	55.7	60.2	70.5	69.8	69.4
Net external debt/GDP (in percent) 4/	15.3	12.1	11.9	16.7	21.3	21.8	21.7
General government external debt/GDP (in percent)							
Excluding government assets held abroad	4.9	3.5	2.9	2.9	3.0	2.7	2.5
Including government assets held abroad 5/	2.3	2.0	-0.5	-2.6	-2.1	-1.9	-1.8
Exchange rate (EEK/US$ - period average) 6/	14.7	17.0	17.6	16.6	13.9	…	…
Money and credit (year-on-year growth in percent)							
Domestic credit to nongovernment	6.3	30.3	22.2	27.8	27.0	24.3	14.9
Base money	27.1	14.6	-9.8	-1.5	14.6	9.0	8.1
Broad money	23.7	25.7	23.0	11.2	10.9	15.1	9.4

Social indicators (reference year) **population** (2000): 1.3642 million; **per capita GDP** (2003): €5,460
life expectancy at birth (2001): 76.4 (female) and 65.1 (male)

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

1/ Lower reserve requirements introduced in 2001 have led to a decline in international reserves under the mechanics of the currency board, which was more than compensated by the improvement in the net foreign asset position of commercial banks. In addition, net short term debt of the banking system has become negative.

2/ Starting in 2000, the definition of external debt was widened to include money market instruments and financial derivatives.

3/ Includes use of Fund credit and trade credits.

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

5/ Government assets held abroad include the Stabilization Reserve Fund (SRF).

6/ Estonian kroon is pegged at 15.64664 kroons to the euro.

Table 2. Estonia: Summary of General Government Operations, 1999–2005
(In millions of EEK)

	1999	2000	2001	2002	2003	2004 Proj.	2005 Proj.
Revenue and grants	29,688	33,062	36,887	42,786	48,413	54,947	57,894
Revenue	29,385	32,795	36,257	42,073	46,918	49,638	53,325
Tax revenue	26,849	29,393	32,073	37,173	41,324	44,465	47,801
Direct taxes	17,622	18,250	19,812	22,826	25,713	26,557	28,046
Personal income tax	6,531	6,594	7,099	7,806	8,818	8,697	8,554
Corporate profits tax	1,635	855	748	1,348	2,156	2,133	2,556
Social security tax	5,520	6,297	6,988	7,712	8,109	8,559	9,185
Medical insurance tax	3,588	4,093	4,542	5,048	5,615	6,063	6,590
Unemployment insurance tax	…	…	…	493	573	616	670
Land and property taxes	347	411	435	418	441	490	490
VAT	6,417	8,153	8,639	10,172	11,187	12,679	14,248
Excises	2,685	2,819	3,434	3,938	4,162	4,859	5,138
Other taxes (incl. on intern. trade)	126	170	187	238	263	369	369
Nontax revenue	2,536	3,402	4,185	4,901	5,595	5,174	5,524
Grants	304	267	630	713	1,494	5,309	4,569
Expenditure	33,187	33,968	36,548	41,634	45,346	53,943	57,804
Current expenditure	29,827	31,232	33,389	37,415	41,491	47,780	51,603
Expenditure on goods and services	19,764	20,368	21,650	24,219	26,613	29,894	32,064
Wages and salaries	6,752	7,085	7,355	8,346	10,117	9,608	10,456
Other goods and services	13,012	13,284	14,296	15,873	16,496	20,287	21,607
of which: healthcare	...	2,878	2,792	2,970	3,683	4,044	4,401
Current transfers and subsidies	9,755	10,568	11,481	12,929	14,556	17,484	19,138
Subsidies	689	682	805	1,138	1,404	2,413	2,256
Transfers to households	9,066	9,886	10,676	11,791	13,153	14,170	15,338
of which: Pensions	6,425	6,445	6,610	7,279	8,294	8,609	9,286
Family benefits	1,156	1,317	1,314	1,394	1,411	1,857	2,021
Sickness benefits	607	716	738	804	869	963	1,048
Unemployment benefits	120	120	133	104	231	382	416
Income maintenance	315	315	358	342	334	243	265
Disability benefits	0	64	441	564	598	603	657
Prescription drug benefits	0	430	644	766	736	834	908
Other	442	480	439	538	680	677	736
Transfers to the EU budget	...	...	...	...	...	902	1,544
Interest payments	309	296	258	267	322	402	402
Capital expenditure	3,360	2,736	3,158	4,219	3,855	6,162	6,201
Financial surplus (+) / deficit (-)	-3,499	-906	339	1,152	3,066	1,005	90
Net lending	-14	-329	-63	-132	0	-70	-140
Overall surplus (+) / deficit (-)	-3,485	-577	402	1,284	3,066	1,075	230
Borrowing requirement	3,485	577	-402	-1,284	...	...	...
Domestic financing	3,833	920	1,639	670	...	...	...
Of which: Privatization	3,024	812	1,970	474	...	...	...
Foreign financing	-349	-343	-2,035	-1,954	...	...	...
Of which : change in government deposits held abroad (-	-431	-23	-1,841	-2,692	...	...	...
Memorandum items:							
Overall balance excluding cost of pension reform	...	...	...	1,339	...	...	...
Primary fiscal balance (+, surplus)	-3,176	-281	660	1,551	3,389	1,476	631
Balance in government deposits held abroad	1,696	1,719	3,560	6,252	...	...	...
Total general government debt							
Excluding government assets held abroad	4,967	4,303	4,384	5,597	...	...	...
Including government assets held abroad	3,271	2,584	824	-655	...	...	...
National defense expenditure	1,061	1,396	1,762	2,028	...	...	...

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

Table 3. Estonia: Summary of General Government Operations, 1999–2005
(In percent of GDP)

	1999	2000	2001	2002	2003	2004 Proj.	2005 Proj.
Revenue and grants	36.4	35.7	35.4	36.6	38.5	39.8	38.5
Revenue	36.0	35.4	34.7	36.0	37.3	35.9	35.5
Tax revenue	32.9	31.7	30.7	31.8	32.8	32.2	31.8
Direct taxes	21.6	19.7	19.0	19.5	20.4	19.2	18.7
Personal income tax	8.0	7.1	6.8	6.7	7.0	6.3	5.7
Corporate profits tax	2.0	0.9	0.7	1.2	1.7	1.5	1.7
Social security tax	6.8	6.8	6.7	6.6	6.4	6.2	6.1
Medical insurance tax	4.4	4.4	4.4	4.3	4.5	4.4	4.4
Unemployment insurance tax	...	...	...	0.4	0.5	0.4	0.4
Land and property taxes	0.4	0.4	0.4	0.4	0.4	0.4	0.3
VAT	7.9	8.8	8.3	8.7	8.9	9.2	9.5
Excises	3.3	3.0	3.3	3.4	3.3	3.5	3.4
Other taxes (incl. on intern. trade)	0.2	0.2	0.2	0.2	0.2	0.3	0.2
Nontax revenue	3.1	3.7	4.0	4.2	4.4	3.7	3.7
Grants	0.4	0.3	0.6	0.6	1.2	3.8	3.0
Expenditure	40.7	36.6	35.0	35.6	36.0	39.0	38.4
Current expenditure	36.5	33.7	32.0	32.0	33.0	34.6	34.3
Expenditure on goods and services	24.2	22.0	20.8	20.7	21.1	21.6	21.3
Wages and salaries	8.3	7.6	7.0	7.1	8.0	7.0	7.0
Other goods and services	15.9	14.3	13.7	13.6	13.1	14.7	14.4
of which: healthcare	...	3.1	2.7	2.5	2.9	2.9	2.9
Current transfers and subsidies	11.9	11.4	11.0	11.1	11.6	12.7	12.7
Subsidies	0.8	0.7	0.8	1.0	1.1	1.7	1.5
Transfers to households	11.1	10.7	10.2	10.1	10.5	10.3	10.2
of which: Pensions	7.9	7.0	6.3	6.2	6.6	6.2	6.2
Family benefits	1.4	1.4	1.3	1.2	1.1	1.3	1.3
Sickness benefits	0.7	0.8	0.7	0.7	0.7	0.7	0.7
Unemployment benefits	0.1	0.1	0.1	0.1	0.2	0.3	0.3
Heating & housing allowance	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Income maintenance	0.4	0.3	0.3	0.3	0.3	0.2	0.2
Disability benefits	0.0	0.1	0.4	0.5	0.5	0.4	0.4
Prescription drug benefits	0.0	0.5	0.6	0.7	0.6	0.6	0.6
Other	0.5	0.5	0.4	0.5	0.5	0.5	0.5
Transfers to the EU budget	...	...	...	...	...	0.7	1.0
Interest payments	0.4	0.3	0.2	0.2	0.3	0.3	0.3
Capital expenditure	4.1	3.0	3.0	3.6	3.1	4.5	4.1
Financial surplus (+) / deficit (-)	-4.3	-1.0	0.3	1.0	2.4	0.7	0.1
Net lending	0.0	-0.4	-0.1	-0.1	0.0	-0.1	-0.1
Overall surplus (+) / deficit (-)	-4.3	-0.6	0.4	1.1	2.4	0.8	0.2
Borrowing requirement	4.3	0.6	-0.4	-1.1	...	...	...
Domestic financing	4.7	1.0	1.6	0.6	...	...	...
Of which: Privatization	3.7	0.9	1.9	0.4	...	...	...
Foreign financing	-0.4	-0.4	-2.0	-1.7	...	...	...
Of which : change in government deposits held abroad (-	-0.5	0.0	-1.8	-2.3	...	...	...
Memorandum items:							
Overall balance excluding cost of pension reform	...	...	...	1.1	...	...	...
Primary fiscal balance (+, surplus)	-3.9	-0.3	0.6	1.3	2.7	1.1	0.5
Balance in government deposits held abroad	2.1	1.9	3.4	5.3	...	...	...
Total general government debt							
Excluding government assets held abroad	6.1	4.6	4.2	4.8	...	...	...
Including government assets held abroad	4.0	2.8	0.8	-0.6	...	...	...
National defense expenditure	1.4	1.6	1.8	1.7	...	...	...
Nominal GDP	81,640	92,717	104,338	116,869	125,832	138,162	150,367

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

Table 4. Estonia: Summary Balance of Payments 1999–2009

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
						Proj.					
	(In millions of euro)										
Current Account	-231	-326	-376	-759	-1,059	-991	-915	-736	-706	-673	-628
Primary Current Account /1	-161	-171	-102	-545	-636	-568	-493	-389	-356	-326	-348
Trade Balance	-773	-840	-881	-1,150	-1,397	-1,477	-1,500	-1,475	-1,516	-1,564	-1,675
Exports	2,364	3,601	3,750	3,713	4,061	4,597	5,058	5,521	5,967	6,444	6,927
Of which : goods for processing	741	1,523	1,422	1,144	1,248	1,413	1,555	1,697	1,834	1,981	2,129
Imports	-3,138	-4,441	-4,630	-4,878	-5,457	-6,074	-6,559	-6,996	-7,482	-8,008	-8,602
Of which : goods for processing	-673	-1,374	-1,141	-965	-1,079	-1,201	-1,297	-1,383	-1,479	-1,583	-1,701
Services Balance	533	612	649	519	751	833	934	1,020	1,087	1,159	1,242
Receipts	1,403	1,629	1,845	1,807	1,969	2,150	2,358	2,538	2,706	2,884	3,080
of which: travel and tourism	518	549	569	585	596	696	763	821	875	933	997
Payments	-870	-1,017	-1,196	-1,289	-1,218	-1,317	-1,424	-1,518	-1,618	-1,725	-1,839
Income	-96	-223	-315	-350	-507	-445	-444	-456	-455	-454	-454
Current Transfers	106	125	170	152	94	99	96	101	106	111	118
Capital and Financial Account	378	480	311	869	1,213	1,023	977	874	842	815	840
Capital Transfers	1	18	6	20	35	24	29	41	41	41	41
Financial Account	377	462	305	848	1,178	999	948	833	801	774	799
Direct Investment	205	358	377	167	667	453	389	343	319	316	302
From abroad	284	425	603	307	797	590	534	496	481	487	481
Outward (by Estonians)	-79	-67	-225	-140	-130	-137	-145	-153	-161	-170	-180
Net equity investment	222	-31	51	59	29	51	51	51	51	51	51
Loans and other investments 2/	-50	135	-124	622	482	495	508	438	430	406	446
of which:											
Banks	6	161	-104	340	697	395	408	358	356	332	372
Government	-31	12	-133	-142	-209	-72	-72	-72	-72	-72	-72
Monetary Authorities	-13	-8	-13	38	37	37	37	37	37	37	37
Errors and Omissions	-33	-9	19	35	-6	0	0	0	0	0	0
Overall balance	115	145	-47	59	149	33	62	63	64	67	70
Memorandum Items:											
EEK/EURO exchange rate (period average)	15.6	15.6	15.6	15.6	15.6	...	...	...	...	...	...
Gross International Reserves (EURO millions) 3/ 4/ :	852	992	930	958	1,107	1,139	1,201	1,264	1,327	1,394	1,464
In months of imports	3.3	2.7	2.4	2.4	2.4	2.3	2.2	2.2	2.1	2.1	2.0
Relative to gross short-term debt (ratio) 6/ 7/	0.9	0.8	0.7	0.6	0.6	0.6	0.5	0.5	0.5	0.5	0.5
	(In percent of GDP)										
Trade Balance	-14.8	-14.2	-13.2	-15.4	-17.4	-16.7	-15.6	-14.2	-13.6	-13.0	-13.0
Goods and Non-factor Services balance	-4.6	-3.8	-3.5	-7.1	-8.0	-7.3	-5.9	-4.4	-3.8	-3.4	-3.4
Current Account	-4.4	-5.5	-5.6	-10.2	-13.2	-11.2	-9.5	-7.8	-7.0	-6.2	-6.0
Primary Current Account /1	-3.1	-2.9	-1.5	-7.3	-7.9	-6.4	-5.1	-3.7	-3.2	-2.7	-2.7
Services	10.2	10.3	9.7	8.3	9.3	9.4	9.7	9.8	9.7	9.7	9.6
Income	-2.0	-3.8	-4.7	-4.6	-6.3	-5.0	-4.6	-4.4	-4.1	-3.8	-3.5
Interest	-0.6	-0.7	-0.7	-0.6	-0.5	-0.7	-0.8	-0.9	-0.9	-1.0	-1.1
Reinvested earnings	-0.7	-1.9	-3.4	-2.3	-4.7	-4.1	-3.6	-3.2	-2.8	-2.5	-2.2
Total external debt 8/											
Gross	58.7	54.7	55.7	60.2	70.5	69.8	69.4	68.6	67.6	66.2	65.0
Net 9/	15.3	12.1	11.9	16.7	21.3	21.8	21.7	21.4	21.0	20.6	20.0
General government external debt 10/											
Excluding Govt. assets held abroad	4.9	3.5	2.9	2.9	3.0	2.7	2.5	2.3	2.1	2.0	1.8
Including Govt. assets held abroad	2.3	2.0	-0.5	-2.6	-2.1	-1.9	-1.8	-1.6	-1.5	-1.4	1.8
Debt Service/Exports of GNFS (in percent)	7.4	6.8	8.0	9.7	11.3	11.0	10.8	10.6	10.4	10.2	10.1

Sources: Bank of Estonia and Fund staff estimates.

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

Table 5. Estonia Banking Survey and Monetary Authorities: 2000–04
(In millions of EEK, unless otherwise indicated)

	2000	2001	2002	2003	2004		
					May	June	July
Banking Survey							
Net foreign assets	9,098	12,285	7,756	-1,072	-6,362	-7,331	-7,725
Net foreign assets (BOE)	15,167	14,319	14,890	16,709	17,973	17,389	18,398
Foreign assets 1/	15,540	14,573	14,995	17,195	18,534	17,416	18,599
Foreign liabilities	-373	-254	-105	-485	-561	-27	-202
Net foreign assets (commercial banks)	-6,068	-2,034	-7,134	-17,781	-24,335	-24,720	-26,122
Foreign assets	10,359	15,475	16,504	17,074	22,154	22,306	21,981
Foreign liabilities	-16,427	-17,510	-23,638	-34,854	-46,489	-47,026	-48,103
Net domestic assets	24,064	28,518	37,619	51,376	58,328	60,642	61,448
Domestic credit	33,758	41,994	53,568	68,933	75,940	77,414	78,619
Net credit to general government	**-1,078**	**-575**	**-834**	**-162**	**-775**	**-832**	**-1,217**
Credit to government (banks)	1,268	1,742	2,439	2,850	2,932	2,581	2,599
Government deposits (banks)	-2,343	-2,311	-3,268	-3,007	-3,703	-3,409	-3,810
Net credit to government (BOE)	3	1	0	0	0	0	0
Government deposits (BOE)	-7	-8	-6	-5	-5	-5	-5
Credit to nongovernment	**34,837**	**42,570**	**54,402**	**69,095**	**76,716**	**78,246**	**79,836**
Credit to nonfinancial public enterprises	263	142	245	221	610	618	615
Credit to private sector	22,203	26,321	31,512	41,769	48,196	49,091	50,218
Credit to enterprises	15,376	17,161	18,625	22,696	25,664	25,924	26,322
Credit to households	6,827	9,160	12,887	19,073	22,532	23,167	23,896
Credit to nonbank financial institutions	12,370	16,107	22,644	27,105	27,910	28,537	29,003
Other items (net)	-9,695	-13,476	-15,949	-17,558	-17,612	-16,771	-17,171
Broad money	**33,162**	**40,803**	**45,374**	**50,304**	**51,966**	**53,268**	**53,724**
M1	20,869	24,948	27,275	30,807	32,166	33,174	33,747
Currency outside banks	**6,201**	**6,952**	**6,995**	**7,140**	**7,145**	**7,316**	**7,471**
Demand deposits	14,668	17,996	20,280	23,667	25,021	25,859	26,277
Time and savings deposits	12,293	15,855	18,100	19,497	19,800	20,094	19,976
Monetary Authorities							
Net foreign assets	15,167	14,319	14,890	16,709	17,973	17,389	18,398
Foreign assets 1/	15,540	14,573	14,995	17,195	18,534	17,416	18,599
of which: currency board cover 2/	13,207	11,910	11,732	13,450	14,650	14,061	15,037
Foreign liabilities	-373	-254	-105	-485	-561	-27	-202
Net domestic assets	-1,960	-2,409	-3,158	-3,259	-3,323	-3,328	-3,361
Net claims on Government	-4	-6	-5	-5	-5	-5	-5
Claims on financial institutions	10	8	9	0	0	0	0
Claims on private sector	70	75	79	75	56	56	56
Other	-2,035	-2,486	-3,240	-3,330	-3,375	-3,379	-3,412
Base money	**13,207**	**11,910**	**11,732**	**13,450**	**14,650**	**14,061**	**15,037**
Currency issue	7,277	8,067	8,113	8,324	8,177	8,388	8,485
Deposits of commercial banks with the BOE	5,718	3,815	3,565	5,063	6,386	5,620	6,502
Other deposits at BOE	211	28	54	64	87	53	50
Memorandum items:							
Base money multiplier	2.51	3.43	3.87	3.74	3.55	3.79	3.57
Currency-to-deposit ratio	0.23	0.21	0.18	0.17	0.16	0.16	0.16
Bank reserves-to-deposit ratio	0.25	0.14	0.12	0.14	0.17	0.15	0.16
Velocity (period average)	2.81	2.57	2.20	2.44	2.57	2.55	2.52
Required reserves (in millions of EEK) 3/	4,634	5,904	6,945	9,449	12,196	12,883	13,043
Net international reserves (in millions of euro) 4/	149	179	210	220	224	224	223
	(Year-on-year, in percent)						
Net foreign assets of banking system	13.4	35.0	-36.9	-113.8	-202.2	-243.4	-335.0
Net domestic assets of banking system	31.0	18.5	31.9	36.6	41.1	42.2	38.4
Domestic credit	27.2	24.4	27.6	28.7	31.2	30.2	28.4
Credit of banking system to non-government	30.3	22.2	27.8	27.0	29.0	27.9	26.7
Credit to the private sector	11.7	18.5	19.7	32.5	38.7	38.7	37.6
Credit to nonbank financial institutions	90.6	30.2	40.6	19.7	14.2	11.9	10.4
Broad money	25.7	23.0	11.2	10.9	9.2	11.5	12.6
M1	20.4	19.5	9.3	13.0	13.2	13.5	14.6
Base money 5/	14.6	-9.8	-1.5	14.6	16.7	19.5	19.8

Source: Bank of Estonia and Fund staff estimates.

1/ Excludes foreign assets of the central government's SRF.
2/ Currency board cover is equivalent to base money (e.g., the sum of currency issue plus the kroon liabilities of the Bank of Estonia in its correspondent accounts).
3/ Requirement to be met on the basis of daily average of deposits over month. Up to June 2000, it includes liquidity requirement equivalent to 3 percent of the reserve requirement base (imposed since December 1997). After June 2000, the liquidity requirement was incorporated in the reserve requirement. Starting in January 2001, 3 percentage points of the 13 percent reserve requirement could be met with high quality euro-denominated foreign instruments. In July 2001, this foreign share of reserve requirements was raised to 50 percent.
4/ Net of currency board cover. ECU through 1998, euro thereafter.
5/ The fall in base money in 2001 is associated with a reduction in the cash reserve requirements.

Table 6. Estonia: Macroeconomic Framework, 1999–2009
(In percent of GDP, unless otherwise indicated)

	1999	2000	2001	2002	2003	2004 Proj.	2005 Proj.	2006 Proj.	2007 Proj.	2008 Proj.	2009 Proj.
Domestic saving	20.5	22.4	23.6	21.6	18.0	19.7	20.6	21.8	22.4	23.1	23.6
Private	20.7	20.0	20.1	16.9	12.5	14.4	16.3	17.5	17.9	18.7	19.1
Public	-0.2	2.3	3.4	4.7	5.5	5.2	4.3	4.2	4.5	4.5	4.5
Investment	25.0	27.9	29.2	31.8	31.1	30.9	30.1	29.6	29.4	29.3	29.5
Private	20.8	24.9	26.2	28.2	28.1	26.4	26.0	25.4	24.9	24.9	25.1
Public	4.1	3.0	3.0	3.6	3.1	4.5	4.1	4.2	4.5	4.5	4.5
Foreign saving	4.4	5.5	5.6	10.2	13.2	11.2	9.5	7.8	7.0	6.2	6.0
Memorandum items:											
Fiscal balance 1/	-4.3	-0.6	0.4	1.1	2.4	0.8	0.2	0.0	0.0	0.0	0.0
Revenues and grants	36.4	35.7	35.4	36.6	38.5	39.8	38.5	38.0	38.2	38.0	37.9
Expenditure and net lending	40.6	36.3	35.0	35.5	36.0	39.0	38.3	38.0	38.2	38.0	37.9
Net non-debt creating capital inflows ("+" inflow)	8.8	5.9	6.9	3.8	8.7	5.7	4.6	3.8	3.3	3.1	2.7
Net equity investment	4.6	-0.6	0.8	0.9	0.4	0.6	0.5	0.5	0.5	0.4	0.4
Net foreign direct investment	4.2	6.4	6.0	2.9	8.3	5.1	4.0	3.3	2.9	2.6	2.3
GDP real growth (year-on-year in percent)	-0.1	7.8	6.4	7.2	5.1	5.8	5.4	5.2	5.0	5.0	5.0
CPI inflation (average, year-on-year in percent)	3.3	4.0	5.8	3.6	1.3	3.0	2.5	2.5	2.5	2.5	2.5
CPI inflation (end-period, in percent)	3.9	5.1	4.2	2.7	1.1	4.4	1.2	2.5	2.5	2.5	2.5
GDP (millions of kroons)	81,640	92,717	104,338	116,869	125,832	138,162	150,367	162,141	174,504	187,810	202,130

Sources: Estonian authorities, and Fund staff estimates.

1/ Includes the impact of the pension reform.

Table 7. Estonia: Indicators of External Vulnerability, 1999–2004
(In percent of GDP, unless otherwise indicated)

	1999	2000	2001	2002	2003	2004	
						Projection	Date Actual data
Financial indicators							
Public sector debt 1/	6.1	4.6	4.2	4.8	5.3	5.4	
Broad money (year-on-year, in percent)	23.7	25.7	23.0	11.2	10.9	12.6	7/31/2004
M1 (year-on-year, in percent)	32.1	20.4	19.5	9.3	13.0	14.6	7/31/2004
Private sector credit (year-on-year, in percent)	6.9	11.7	18.5	19.7	32.5	37.6	7/31/2004
External Indicators							
Exports (percent change, annual average, in euro)	-2.1	52.3	4.1	-1.0	9.4	13.2	
Imports (percent change, annual average, in euro)	-8.3	41.5	4.3	5.3	11.9	11.3	
Current account balance	-4.4	-5.5	-5.6	-10.2	-13.2	-11.2	
Capital and financial account balance	7.2	8.1	4.7	11.6	15.1	11.6	
of which: Inward portfolio investment (debt securities etc.)	2.5	1.4	1.4	4.8	6.0	...	
Other investment (loans, trade credits etc.)	3.1	-0.2	-0.4	6.4	4.6	6.2	
Inward foreign direct investment	5.4	7.2	9.0	4.1	9.4	6.7	
in the form of debt or loans	1.8	1.4	2.7	1.2	1.9	1.5	
Gross official reserves (in euro millions)	852	992	930	958	1,107	1,139	
NFA of the consolidated banking system (in euro millions)	513	581	785	496	-68	-494	7/31/2004
Central Bank short-term foreign liabilities (in euro millions)	0.2	3.3	1.0	6.4	30.7	12.6	7/31/2004
Short term foreign assets of the financial sector (in euro millions) 2/	422	490	945	1,312	1,845	1,965	
Short term foreign liabilities of the financial sector (in euro millions)	684	868	979	1,399	1,733	1,864	
Foreign currency exposure of the financial sector (in euro millions)	469	510	1,064	1,576	2,007	1,924	7/31/2004
Official reserves in months of imports (excluding imports of goods for processing)	4.1	3.9	3.2	2.9	3.0	2.8	
Broad money to reserves	2.0	2.1	2.8	3.0	2.9	3.0	7/31/2004
Total short term external debt to reserves 3/	1.1	1.2	1.4	1.6	1.7	1.8	
Total external debt 4/	58.7	54.7	55.7	60.2	70.5	69.8	
of which: Public sector debt 1/	4.9	3.5	2.9	2.9	3.0	2.7	
Net external debt 5/	15.3	12.1	11.9	16.7	21.3	21.8	
Debt service to exports of GNFS	7.4	6.8	8.0	9.7	11.3	11.0	
External interest payments to exports of GNFS	-2.0	-2.6	-2.8	-2.7	-2.6	...	
External amortization payments to exports of GNFS, in percent	7.0	5.6	6.1	7.9	9.6	9.0	
Exchange rate (per US$, period average)	14.7	17.0	17.5	16.6	13.9	12.9	8/31/2004
REER, eop, appreciation (+)	-4.4	-3.8	1.2	3.3	2.5	2.6	4/30/2004
Financial Market Indicators							
Stock market index 6/	125.5	138.2	144.7	212.5	285.7	344.0	5/4/2004
Foreign currency debt rating 7/	BBB+	BBB+	A-	A-	A-	A-	5/4/2004
Spread of benchmark bonds (basis points, end of period) 8/	0.7	0.4	0.04	32.6	31.7	6.2	5/11/2004

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

1/ Total general government and government guaranteed debt excluding government assets held abroad.
2/ Excluding reserve assets of the Bank of Estonia.
3/ By original maturity.
4/ Starting in 2000, the definition of external debt was widened to include money market instruments and financial derivatives.
5/ Net of portfolio assets (including money market instruments), financial derivative assets, other investment assets, and reserve assets held by Estonian residents.
6/ Tallinn stock exchange index (TALSE), end of period.
7/ Standard & Poor's long-term foreign exchange sovereign rating.
8/ 1999-2001: one-month spread between Tallinn interbank borrowing rate (TALIBOR) and the corresponding EURIBOR rate. Since 2002: 5-year government bond spread over comparable German bund.

Table 8. Estonia: External Debt Sustainability Framework, 1999–2009

(In percent of GDP, unless otherwise indicated)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
	Actual					Projections					
I. Baseline Medium-Term Projections											
External debt	54.9	54.7	55.7	60.2	**70.5**	**69.8**	**69.4**	**68.6**	**67.6**	**66.2**	**65.0**
Change in external debt	4.8	-0.1	1.0	4.5	10.3	-0.7	-0.4	-0.8	-1.0	-1.4	-1.2
Identified external debt-creating flows (4+8+11)	-5.8	-6.7	-7.0	1.2	0.2	-0.8	-0.7	-1.0	-1.2	-1.6	-1.5
Current account deficit, excluding interest payments	2.9	3.9	4.1	8.9	11.8	9.3	7.3	5.2	4.0	2.9	2.6
Deficit in balance of goods and services	4.6	3.8	3.5	7.1	8.0	7.3	5.9	4.4	3.8	3.4	3.3
Exports	72.2	88.3	83.9	74.1	75.0	76.4	77.2	77.8	77.8	77.7	77.5
Imports	76.8	92.1	87.4	81.2	83.0	83.7	83.1	82.2	81.6	81.1	80.8
Net non-debt creating capital inflows (negative)	-8.2	-5.5	-6.4	-3.0	-8.7	-5.7	-4.6	-3.8	-3.3	-3.1	-2.7
Net foreign direct investment, equity	3.9	6.0	5.7	2.2	8.3	5.1	4.0	3.3	2.9	2.6	2.3
Net portfolio investment,equity	4.3	-0.5	0.8	0.8	0.4	0.6	0.5	0.5	0.5	0.4	0.4
Automatic debt dynamics 1/	-0.5	-5.0	-4.7	-4.7	-2.9	-4.3	-3.5	-2.4	-1.9	-1.4	-1.4
Contribution from nominal interest rate	1.5	1.5	1.4	1.3	1.4	1.9	2.2	2.6	3.0	3.4	3.3
Contribution from real GDP growth	0.0	-3.8	-3.1	-3.6	-2.9	-3.7	-3.5	-3.3	-3.2	-3.1	-3.1
Contribution from price and exchange rate changes 2/	-2.1	-2.8	-3.0	-2.4	-1.4	-2.6	-2.2	-1.7	-1.7	-1.6	-1.6
Residual, incl. change in gross foreign assets (2-3) 3/	10.6	6.6	8.0	3.3	10.1	0.1	0.3	0.2	0.2	0.2	0.2
External debt-to-exports ratio (in percent)	76.0	62.0	66.4	81.2	94.0	91.4	90.0	88.2	87.0	85.2	83.9
Gross external financing need (in billions of EURO) 4/	1.3	1.4	1.6	2.1	3.3	3.6	3.7	3.8	3.9	4.0	4.2
in percent of GDP	25.4	23.1	24.4	28.8	40.6	40.9	38.9	36.8	35.2	33.6	32.7
Key Macroeconomic and External Assumptions											
Nominal GDP (US dollars)	5.2	5.9	6.7	7.5	8.0	8.8	9.6	10.4	11.2	12.0	12.9
Real GDP growth (in percent)	-0.1	7.8	6.4	7.2	5.1	5.8	5.4	5.2	5.0	5.0	5.0
GDP deflator in EURO (change in percent)	4.3	5.3	5.8	4.4	2.4	3.8	3.3	2.5	2.5	2.5	2.5
Nominal external interest rate (in percent)	3.2	3.1	2.9	2.6	2.5	3.0	3.4	4.1	4.7	5.4	5.4
Growth of exports (in EURO, in percent)	0.6	38.8	7.0	-1.1	8.9	11.9	9.9	8.7	7.6	7.6	7.3
Growth of imports (in EURO, in percent)	-5.4	36.2	6.7	4.1	10.0	10.7	8.0	6.7	6.9	6.9	7.3
II. Stress Tests for External Debt Ratio											
1. Real GDP growth, nominal interest rate, dollar deflator, non-interest current account, and non-debt inflows are at historical average					**70.5**	**65.1**	**60.4**	**55.8**	**51.7**	**47.8**	**44.3**
2. Nominal interest rate is at historical average plus two standard deviations in 2004 and 2005					**70.5**	**76.7**	**83.2**	**81.9**	**80.5**	**78.8**	**77.3**
3. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005					**70.5**	**75.3**	**80.3**	**79.1**	**77.8**	**76.2**	**74.7**
4. Change in EURO GDP deflator is at historical average minus two standard deviations in 2004 and 2005					**70.5**	**75.0**	**79.6**	**78.4**	**77.1**	**75.5**	**74.1**
5. Non-interest current account is at historical average minus two standard deviations in 2004 and 2005					**70.5**	**73.2**	**78.1**	**76.9**	**75.7**	**74.1**	**72.7**
6. Combination of 2-5 using one standard deviation shocks					**70.5**	**78.4**	**88.1**	**86.6**	**85.1**	**83.3**	**81.8**
7. One time 30 percent nominal depreciation in 2004 5/					**70.5**	**98.2**	**96.4**	**94.6**	**92.9**	**91.0**	**89.2**

Historical Statistics for Key Variables (past 10 years, GDP deflator past 8 years)	Historical Average	Standard Deviation	Average 2004-09
Current account deficit, excluding interest payments	6.6	3.1	5.2
Net non-debt creating capital inflows	6.6	2.5	3.9
Nominal external interest rate (in percent)	4.7	4.5	4.3
Real GDP growth (in percent)	5.2	3.8	5.2
GDP deflator in EURO (change in percent)	7.8	5.8	2.8

1/ Derived as [r - g - ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, 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 [-ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock. ρ increases with an appreciating domestic currency (ε > 0) and rising inflation (based on GDP deflator).

3/ The large historical residual is due to foreign asset transactions.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ Standard exercise undertaken for all member countries irrespective of their exchange rate regime according to Assessing Sustainability, May 8, 2002 (www.imf.org) and Sustainability Assessments-Review of Application and Methodological Refinements, June 10, 2003 (www.imf.org).

Table 8a. Estonia: External Debt Sustainability Framework, 1999–2009

(In percent of GDP, unless otherwise indicated)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
	Actual					Projections					
I. Worse-case Medium-Term Projections											
External debt	54.9	54.7	55.7	60.2	**70.5**	**69.8**	**70.7**	**72.5**	**74.5**	**76.1**	**77.2**
Change in external debt	4.8	-0.1	1.0	4.5	10.3	-0.7	0.9	1.8	2.0	1.7	1.1
Identified external debt-creating flows (4+8+11)	-5.8	-6.7	-7.0	1.2	0.2	-0.8	0.6	1.6	1.7	1.5	0.9
Current account deficit, excluding interest payments	2.9	3.9	4.1	8.9	11.8	9.3	8.6	7.7	6.9	5.9	5.1
Deficit in balance of goods and services	4.6	3.8	3.5	7.1	8.0	7.3	7.2	7.1	7.1	6.9	6.4
Exports	72.2	88.3	83.9	74.1	75.0	76.4	77.2	77.8	77.8	77.7	77.5
Imports	76.8	92.1	87.4	81.2	83.0	83.7	84.3	84.8	84.8	84.7	83.9
Net non-debt creating capital inflows (negative)	-8.2	-5.5	-6.4	-3.0	-8.7	-5.7	-4.6	-3.8	-3.3	-3.1	-2.7
Net foreign direct investment, equity	3.9	6.0	5.7	2.2	8.3	5.1	4.0	3.3	2.9	2.6	2.3
Net portfolio investment,equity	4.3	-0.5	0.8	0.8	0.4	0.6	0.5	0.5	0.5	0.4	0.4
Automatic debt dynamics 1/	-0.5	-5.0	-4.7	-4.7	-2.9	-4.3	-3.4	-2.4	-1.8	-1.4	-1.5
Contribution from nominal interest rate	1.5	1.5	1.4	1.3	1.4	1.9	2.2	2.8	3.3	3.9	3.9
Contribution from real GDP growth	0.0	-3.8	-3.1	-3.6	-2.9	-3.7	-3.5	-3.4	-3.4	-3.5	-3.5
Contribution from price and exchange rate changes 2/	-2.1	-2.8	-3.0	-2.4	-1.4	-2.6	-2.2	-1.7	-1.8	-1.8	-1.9
Residual, incl. change in gross foreign assets (2-3) 3/	10.6	6.6	8.0	3.3	10.1	0.1	0.3	0.2	0.2	0.2	0.2
External debt-to-exports ratio (in percent)	76.0	62.0	66.4	81.2	94.0	91.4	91.6	93.2	95.8	98.0	99.7
Gross external financing need (in billions of EURO) 4/	1.3	1.4	1.6	2.1	3.3	3.6	3.9	4.2	4.5	4.8	5.2
in percent of GDP	25.4	23.1	24.4	28.8	40.6	40.9	40.3	40.3	40.3	40.2	40.1
Key Macroeconomic and External Assumptions											
Real GDP growth (in percent)	-0.1	7.8	6.4	7.2	5.1	5.8	5.4	5.2	5.0	5.0	5.0
GDP deflator in EURO (change in percent)	4.3	5.3	5.8	4.4	2.4	3.8	3.3	2.5	2.5	2.5	2.5
Nominal external interest rate (in percent)	3.2	3.1	2.9	2.6	2.5	3.0	3.5	4.2	4.9	5.6	5.6
Growth of exports (in EURO, in percent)	0.6	38.8	7.0	-1.1	8.9	11.9	9.9	8.7	7.6	7.6	7.3
Growth of imports (in EURO, in percent)	-5.4	36.2	6.7	4.1	10.0	10.7	9.7	8.5	7.6	7.4	6.6
II. Stress Tests for External Debt Ratio											
1. Real GDP growth, nominal interest rate, dollar deflator, non-interest current account, and non-debt inflows are at historical average					**70.5**	**65.1**	**60.4**	**55.9**	**51.7**	**47.9**	**44.3**
2. Nominal interest rate is at historical average plus two standard deviations in 2004 and 2005					**70.5**	**76.7**	**84.4**	**85.7**	**87.4**	**88.8**	**89.7**
3. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005					**70.5**	**75.3**	**81.6**	**83.0**	**84.7**	**86.2**	**87.1**
4. Change in EURO GDP deflator is at historical average minus two standard deviations in 2004 and 2005					**70.5**	**75.0**	**80.9**	**82.3**	**84.0**	**85.5**	**86.4**
5. Non-interest current account is at historical average minus two standard deviations in 2004 and 2005					**70.5**	**73.2**	**78.0**	**79.6**	**81.4**	**82.9**	**83.9**
6. Combination of 2-5 using one standard deviation shocks					**70.5**	**78.4**	**88.0**	**89.2**	**90.8**	**92.1**	**92.9**
7. One time 30 percent nominal depreciation in 2004 5/					**70.5**	**98.2**	**97.7**	**98.6**	**99.9**	**101.1**	**101.7**

Historical Statistics for Key Variables (past 10 years, GDP deflator past 8 years)	Historical Average	Standard Deviation	Average 2004-09
Current account deficit, excluding interest payments	6.6	3.1	7.2
Net non-debt creating capital inflows	6.6	2.5	3.9
Nominal external interest rate (in percent)	4.7	4.5	4.5
Real GDP growth (in percent)	5.2	3.8	5.2
GDP deflator in EURO (change in percent)	7.8	5.8	2.8

1/ Derived as [r - g - ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, 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 [-ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock. ρ increases with an appreciating domestic currency (ε > 0) and rising inflation (based on GDP deflator).
3/ The large historical residual is due to foreign asset transactions.
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
5/ Standard exercise undertaken for all member countries irrespective of their exchange rate regime according to Assessing Sustainability, May 8, 2002 (www.imf.org) and Sustainability Assessments-Review of Application and Methodological Refinements, June 10, 2003 (www.imf.org).

Table 9. Estonia: Selected Financial Indicators, 1999–2004

	1999	2000	2001	2002	2003	2004 January	2004 February	2004 March
				(In percent of total deposits)				
Banking sector reserves	28.1	23.2	13.6	11.2	13.5	9.7	10.7	12.7
Cash	4.5	3.7	3.1	2.7	2.6	2.1	2.0	2.0
Required reserves	13.3	15.9	16.3	16.7	20.5	22.0	...	...
Reserves held at the BoE 1/	23.4	19.6	10.5	8.6	11.0	7.6	8.7	10.7
Average risk-weighted capital adequacy ratio	16.1	13.2	14.4	15.3	14.5	14.3	14.2	14.0
Non-performing loans (in percent of total loans) 2/	1.7	1.0	1.3	0.8	0.4	0.4	0.4	0.4
Leverage ratio 3/	5.2	6.6	6.6	7.3	8.1	8.1	8.1	8.1
				(In millions of EEK; unless otherwise indicated)				
NFA of commercial banks	-4,910	-6,068	-2,034	-7,134	-17,781	-15,604	-17,821	-19,944
Net open foreign exchange position of banks	7,335	7,985	16,642	24,666	31,406	31,649	30,309	28,730
In percent of total assets	15.6	13.8	24.3	30.2	31.8	31.8	29.5	27.8
Banking sector's net external obligations maturing within 30 days	-651	2,102	3,832	539	-3,451	1,412	-3,752	-904
Net international reserves of BoE 4/	1,737	2,165	2,533	3,119	3,148	3,143	3,102	...
Interest spread (in percent per annum) 5/								
Domestic currency short-term	5.5	3.2	5.4	2.6	...	...	...	...
Foreign currency (Euro) short term	6.9	5.7	9.2	...	...	...	...	...
Domestic credit to non-government (annual growth, in percent)	6.3	30.3	22.2	27.8	27.0	26.0	27.2	27.7

Source: Bank of Estonia and Fund staff estimates

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

2/ Non-performing loans are defined as loans overdue from 30-150 days and under current regulations all non-performing loans over 150 days are written off. The ratio rose sharply in early 1999 reflecting the impact of the Russia crisis on the financial condition of enterprises.

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

4/ Excludes currency board cover and Government deposits held abroad (including the Stabilization Reserve Fund).

5/ Calculated as the difference between short-term (under 1 year) average lending and deposit rates on domestic and foreign currency loans and deposits.

Table 10. Estonia: Financial and Budgetary Impact of EU Accession, 2004–06
(In millions of EEK)

	Estimated Disbursements			Consolidated Budget Revenue			Consolidated Budget Expenditures (w/o Co-financing)			Consolidated Budget Co-financing (Where Applicable)			Consolidated Budget Savings and Substitution in Exp.			Consolidated Budget Net Impact on the Budget		
	2004	2005	2006	2004	2005	2006	2004	2005	2006	2004	2005	2006	2004	2005	2006	2004	2005	2006
I. Pre-accession aid	1,589	1,013	1,299	1,589	1,013	1,299	-1,589	-1,013	-1,299	-472	-417	-986				-472	-417	-986
PHARE	610	260	29	610	260	29	-610	-260	-29	-115	-61	-5				-115	-61	-5
ISPA	875	753	1,270	875	753	1,270	-875	-753	-1,270	-323	-356	-981				-323	-356	-981
SAPARD	104	0	0	104	0	0	-104	0	0	-34	0	0				-34	0	0
II. EAGGF	1,512	1,731	2,181	1,512	1,731	2,181	-1,512	-1,731	-2,181	-282	-235	-320	282	235	320			
Market regulation	235	303	503	235	303	503	-235	-303	-503	0	-2	-2						
Direct payments	1,001	1,208	1,391	1,001	1,208	1,391	-1,001	-1,208	-1,391	-174	-141	-208						
Rural development	276	220	287	276	220	287	-276	-220	-287	-108	-92	-110						
III. Structural and Cohesion Funds	1,506	1,822	2,669	1,506	1,822	2,669	-1,506	-1,822	-2,669	-451	-564	-805	265	787	1,159	-186	223	354
Structural Funds	1,241	1,035	1,510	1,241	1,035	1,510	-1,241	-1,035	-1,510	-363	-298	-404				-363	-298	-404
Cohesion Fund	265	787	1,159	265	787	1,159	-265	-787	-1,159	-88	-266	-401	265	787	1,159	177	521	758
IV. Internal policies	406	631	519	344	451	400	-344	-451	-400	-17	-55	-24				-17	-55	-24
Current EU	0	0	0	0	0	0	0	0	0	0	0	0				0	0	0
Institutional development	62	180	119	0	0	0	0	0	0	-17	-55	-24				-17	-55	-24
Schengen	344	451	400	344	451	400	-344	-451	-400	0	0	0				0	0	0
V. Special cash transfer	274	50	50	274	50	50										274	50	50
Cash-flow lump-sum	274	50	50	274	50	50										274	50	50
Budget compensation	0	0	0	0	0	0										0	0	0
VI. Other	55	191	141															
EEA financial mechanism	0	107	88															
Other (bileteral help)	55	84	53															
Subtotal	**5,342**	**5,438**	**6,859**	5,225	5,067	6,599	-4,951	-5,017	-6,549									
As percent of GDP	**3.9**	**3.6**	**4.2**	3.8	3.4	4.1	-3.6	-3.3	-4.0									
Estonian contribution to EU budget	-901	-1,617	-1,817				-901	-1,617	-1,817							-901	-1,617	-1,817
Traditional own resources	-114	-285	-310				-114	-285	-310							-114	-285	-310
Vat- based resource	-126	-208	-244				-126	-208	-244							-126	-208	-244
GNP- based resource	-595	-1,012	-1,132				-595	-1,012	-1,132							-595	-1,012	-1,132
UK rebate	-66	-112	-131				-66	-112	-131							-66	-112	-131
Other				1,106	1,181	1,189										1,106	1,181	1,189
Decrease in customs duties				-5	0	0										-5	0	0
Gain from VAT and excise harmonization				1,687	1,048	1,055										1,687	1,048	1,055
Revenue loss from lower efficiency of VAT collection				-700	0	0										-700	0	0
Obligations to EU institutions				0	0	0										0	0	0
Second-round gain in VAT and PIT				124	133	134										124	133	134
Gain in excises				0	0	0										0	0	0
Net position with the EU	**4,441**	**3,821**	**5,042**															
As percent of GDP	**3.2**	**2.5**	**3.1**															
Net impact on the budget				6,331	6,248	7,788	-5,852	-6,634	-8,366	-940	-1,036	-1,815	265	787	1,159	**-197**	**-635**	**-1,234**
As percent of GDP				4.6	4.2	4.8	-4.2	-4.4	-5.2	-0.7	-0.7	-1.1	0.2	0.5	0.7	**-0.1**	**-0.4**	**-0.8**

Source: Ministry of Finance and Fund staff estimates.

Estonia: Fund Relations[1]

(As of July 31, 2004)

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

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

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

Outstanding Purchases and Loans: None

Financial Arrangements:

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

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

Implementation of HIPC Initiative: Not applicable

Safeguards Assessment:

Under the Fund's safeguards assessment policy, the Bank of Estonia was subject to the transitional procedures with respect to the Stand-by Arrangement which was approved on March 1, 2000 and which expired on August 31, 2001. The transitional procedures require a review of only the BoE's external audit mechanism. This assessment determines whether the BoE publishes annual financial statements that are independently audited in accordance with internationally accepted standards. The external audit assessment was completed on

[1] Updated information relating to members positions in the Fund can be found on the IMF web site (http://www.imf.org/external/np/tre/tad/index.htm).

December 13, 2000. The assessment concluded that BoE's external audit mechanism is adequate, as reported in 2001 Article IV Staff Report.

Exchange Arrangements:

The currency of Estonia is the kroon. The kroon replaced the ruble on June 20, 1992. Since that date, the Bank of Estonia has guaranteed the conversion of kroon bank notes, coins, and reserve deposits of commercial banks at a fixed rate of exchange of EEK 15.6466 per euro (and EEK 8 per deutsche mark until 31 December, 2001). Estonia has accepted the obligations of Article VIII, Sections 2, 3, and 4. Estonia maintains an exchange system that is free of restrictions on payments and transfers for current international transactions, apart from restrictions in accordance with the United Nations Security Council Resolutions 1076, 1269, 1333, 1368 and 1373 and the measures adopted by the EU within the framework of the Common Foreign and Security Policy. All such restrictions have been notified to the Fund according to Decision 144-(52/51). It appears that Estonia does not maintain restrictions on capital transactions.

Article IV Consultation:

The 2003 Article IV consultation was concluded by the Executive Board on October 22, 2003.

FSAP Participation and ROSCs:

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

ROSC MODULES

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

Technical Assistance:

TECHNICAL ASSISTANCE FROM THE FUND, 2000–2003

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
STA	Preparation of ROSC data dissemination module	Technical Assistance	May 2001	Bank of Estonia and Ministry of Finance
INS	Financial Markets	Training	September 2002	Bank of Estonia
FAD	Medium-term budget	Technical Assistance	December 2003	Ministry of Finance

Resident Representative:

Mr. Adalbert Knöbl was senior resident representative in Estonia and Latvia until 2002. Since then the office in Estonia has been run by two local staff. His position was not replaced.

Fourth Amendment:

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

Relations with the World Bank

1. Estonia became a member of the World Bank on June 23, 1992. The World Bank's early involvement in Estonia included work on public expenditure issues (1994), local government financing (1995), and the impact of the transition process on living standards (1996). In June 1997, the Bank completed a Public Expenditure Review Update.

2. In June 1999, the World Bank completed a Country Economic Memorandum entitled "*Estonia: Implementing the EU Accession Agenda.*" In February 2000, the World Bank initiated work on a Regional Development Program for the northeastern-most county of Estonia, Ida Virumaa. The work included the development of an action program designed to: (a) strengthen regional institutions providing labor and education services, as well as other social services; (b) support the development of small and medium enterprises; and (c) mitigate past environmental damages, contributing to sustainable development. The work was completed in June 2000. Work is proceeding on the financial sector regulatory system, and the financing of municipalities and reform of the structure of sub-national governments.

3. The Board of Executive Directors approved the first World Bank lending operation in Estonia, a Rehabilitation Loan for US$30 million, in October 1992. In May 1994, loans to support district heating rehabilitation (US$38.4 million) and highway maintenance (US$12 million) were approved. A US$10 million Financial Institutions Development Loan (FIDL) was approved in October 1994, a health project (US$18 million) in January 1995, followed in April 1995 by an environment loan (US$2 million), and an agricultural loan (US$16 million) in March 1996. All the above-mentioned projects have already been completed and closed. In March 2000, the Board approved a Transport Sector Project (US$25 million), focusing primarily on road improvements. The implementation of this project is continuing, and the project closing date is December 31, 2005.

4. In late 2003 Estonia opted to cancel the undisbursed World Bank loan balances. The Bank currently has only one active project (Transport Sector Project), which is due to be closed in 2005. The Bank's local office in Tallinn was closed in June 2001 and no new lending is expected.

ESTONIA—STATISTICAL ISSUES

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

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

A. Monetary Statistics

3. All monetary data are issued by the Bank of Estonia (BoE).[1]

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

B. Financial Statistics

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

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

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

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

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

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

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

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

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

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

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

C. Balance of Payments Statistics

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

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

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

- Quarterly current account data are available with a one-quarter lag.[2]

- Quarterly public and private external debt data are available with a one-quarter lag.[2]

D. Government Finance Statistics

6. All fiscal data are published by the Ministry of Finance (MoF). SDDS related data for central government operations and central government debt have not been disseminated since December 2002. The MoF has introduced a new budget system this year together with new budget classifiers based on GFS2001 and has reported ongoing difficulties in matching the source data into the new framework.

- Monthly central government operations data are available with a lag of up to 25 days after the end of the month. The government has started to report monthly data on a consolidated government basis in January 1999

(http://www.fin.ee/?lang=en). Currently, the MoF is using one of its two allowed SDDS flexibility options on the timeliness of monthly central government operations data, but plans to begin redisseminating these data in the near future.

- Quarterly data on foreign loans and guarantees by the central government are available with a one-month lag. Currently, the MoF is using the second of its two allowed SDDS flexibility options on the timeliness of quarterly central government debt data, but plans to begin redisseminating these data in the near future.

- Comprehensive annual data on central government and local government operations and debt are reported within three quarters from the end of the fiscal year for use in the *GFS Yearbook*. Annual general government operations data (cumulative) for 2002 are available on Estonia's National Summary Data Page (NSDP).

E. National Accounts Statistics

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

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

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

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

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

Estonia: Core Statistical Indicators
(As of September 15, 2004)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/ GNP	External Debt/ Debt Service
Date of Latest Observation	9/3/04	8/31/04	8/31/04	8/31/04	7/31/04	7/04	8/04	7/04	Q1/04	Q4/04	Q1/04	Q1/04
Date Received	9/3/04	9/07/04	9/07/04	9/07/04	8/19/04	8/19/04	9/08/04	9/08/04	6/30/04	4/30/04	6/30/04	6/30/04
Frequency of Data	D	M	M	M	M	M	M	M	Q	M	Q	Q
Frequency of Reporting	D	M	M	M	M	M	M	M	Q	M	Q	Q
Source of Update	N	A	A	A	A	A	A	A	A	A	A	A
Mode of Reporting	E	E	E	E	E	E	E	E	E	E	E	E
Confidentiality	C	C	C	C	C	C	C	C	C	C	C	C
Frequency of Publication	D	M	M	M	M	M	M	M	Q	M	Q	Q

Explanation of abbreviations:
Frequency of data, reporting and publication: D—daily, M—monthly, Q—Quarterly.
Source of data: A—direct reporting by Bank of Estonia, Ministry of Finance, or Statistical Office of Estonia.
Mode of reporting: E—electronic (e-mail or internet).
Confidentiality: C—unrestricted

INTERNATIONAL MONETARY FUND
Public Information Notice
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FOR IMMEDIATE RELEASE
November 11, 2004

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

IMF Concludes 2004 Article IV Consultation with the Republic of Estonia

On November 8, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Estonia.[1]

Background

Estonia's successful economic performance over the last decade culminated in EU accession on May 1, 2004. Estonia joined ERM II, maintaining its currency board at the preexisting peg against the euro. The country has been among the fastest growing of the accession countries: per capita GDP has almost doubled since 1993 and reached around 45 percent of the EU average in 2003 in Purchasing Power Parity terms. However, the external current account deficit deteriorated sharply since 2002 and remains high.

Economic activity has been gathering speed. Year-on-year growth accelerated to 6.8 percent in 2004Q1 from 5.8 percent in 2003Q1, driven by domestic demand and supported by technology sector exports. Inflation accelerated in the first half of 2004 as a result of EU tax harmonization. But no lasting rise in inflationary pressures is foreseen. Unit labor costs increased only modestly, with productivity gains dampening the effect on the growth of real wages.

The external current account deficit widened to 13.2 percent of GDP in 2003. Although it is expected to decline, as part of the deterioration was due to "one-off" investments of about 5 percentage points of GDP related largely to energy and transportation, the underlying current account deficit was higher than its historical average. However, the high current account deficit

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the November 8, 2004 Executive Board discussion based on the staff report.

does not appear attributable to worsening competitiveness—market shares of Estonian exports to the main trading partners increased.

Fiscal policy tightened in 2003: the general government surplus more than doubled to 2.4 percent of GDP. This has occurred in part because of strong revenue performance stemming from stronger-than-expected domestic demand and employment growth. Some of the fiscal tightening, however, resulted from postponed personnel and administrative expenditures and will be reversed in 2004.

Domestic credit growth remained high and was financed mainly by banks' external borrowing from foreign parent banks. Year-on-year credit growth to households accelerated to around 50 percent at the end of the first half of 2004, as households borrowed to acquire real estate. However real estate prices rose only modestly in 2003 and remained stable in the first half of 2004.

Estonia's banking system remains financially sound. The percentage of non-performing loans declined further and, at 0.4 percent of the total, is the lowest among transition countries. Although bank competition and declining interest rates squeezed margins and interest income declined, bank profits remained strong, with income from services fees growing briskly and Estonian banks expanding in neighboring markets.

Executive Board Assessment

Executive Directors welcomed Estonia's accession to the European Union and early entry in ERM II. This followed solid economic performance during the past decade, and a successful transition to a market economy underpinned by prudent fiscal policy, along with flexible labor and product markets. Directors commended the authorities for Estonia's remarkable nominal and real convergence with the EU, and agreed that the economy is well placed to meet the challenges of adopting the euro. They also welcomed the exemplary track record of cooperation between the Fund and the Estonian authorities.

Directors noted that Estonia's high and rising external current account deficit is partly explained by one-off factors, and that a large part of the deficit has been financed by foreign direct investment inflows. Furthermore, Estonia's external competitiveness remains strong. Nevertheless, most Directors agreed with the view that the continuing high current account deficits are a potential cause of concern and may not be sustainable over the medium term.

Looking ahead, Directors underlined the importance of maintaining a prudent fiscal policy stance in order to avoid exacerbating the current account imbalance and to minimize the risks under ERM II in the context of the currency board arrangement, which has served Estonia well. The currency board arrangement remains credible, as indicated by Estonia's relatively high credit rating, and is a viable strategy in the run-up to euro adoption. Directors underscored that macroeconomic and structural policies will need to continue to be carefully directed at underpinning this credibility, with fiscal policy playing the dominant role in restraining domestic demand and curbing inflationary pressures.

Against this background, Directors called on the authorities to maintain in 2005 a fiscal surplus similar to that expected in 2004. Furthermore, over the medium term, the surplus should

decrease only gradually until fiscal balance is achieved. This will be necessary in order to avoid a large and unwelcome fiscal stimulus. Directors considered that such an approach will help to avoid overheating the economy, restore the current account balance to more sustainable levels, and reduce external vulnerabilities.

Directors cautioned the authorities that the planned income tax cuts over 2005–07 will require identifying offsetting savings. Given the primacy of the objective of fiscal restraint, taxes should be reduced only if realistic expenditure cuts, or other revenue sources, have been clearly identified. Further rationalization of the large number of local governments and improvements in intergovernmental finances should provide some relief to the budget and help accommodate the tax cuts and enhance public sector efficiency.

Directors observed that labor market flexibility, and wage increases that are in line with improvements in productivity, will also remain vital for maintaining external competitiveness and supporting the currency board. Moderation in public sector wage growth will be of crucial importance in light of its signaling effect on the private sector. Directors welcomed the authorities' intention to focus efforts on drawing unemployed youth and the long-term unemployed into the labor market through the use of active labor market policies, including better-targeted vocational training to reduce skill mismatches and reform of the unemployment benefits scheme.

Directors commended the successful pension reform in Estonia. Going forward, a key challenge will be to address the needs of an aging population and increasing health care spending while ensuring long-term fiscal sustainability. Directors underscored that the fiscal surpluses required currently for macro stability also represent an opportunity to make appropriate provision for the future needs of Estonian citizens. The recent adoption of multi-year budgeting is a welcome step in achieving this goal.

Directors noted that the banking sector remains well-managed and sound, with adequate capital and low non-performing loan ratios. However, they cautioned that the recent rapid credit growth could pose a risk to macroeconomic and financial stability, and should continue to be monitored carefully. Directors welcomed the authorities' recognition of the need for conservative lending practices, supported the planned reduction in mortgage interest deductibility to limit credit growth, and recommended that consideration be given to tightening prudential controls if needed. Directors also welcomed Estonia's implementation of legislation to combat money laundering and terrorism financing.

Directors commended the completion of most large-scale privatizations and the progress made in restructuring and liberalizing the energy sector.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The Staff Report for the 2004 Article IV Consultation with Estonia is also available.

Republic of Estonia: Selected Economic Indicators

	1999	2000	2001	2002	2003
Real Economy			In units as indicated		
Real GDP growth, in percent	-0.1	7.8	6.4	7.2	5.1
Average CPI inflation, in percent	3.3	4.0	5.8	3.6	1.3
Unemployment rate (ILO definition), in percent	12.2	13.7	12.6	10.3	10.0
Domestic saving, in percent of GDP	20.5	22.4	23.6	21.6	18.0
Domestic investment, in percent of GDP	25.0	27.9	29.2	31.8	31.1
Public Finance			In percent of GDP		
General government balance	-4.3	-0.6	0.4	1.1	2.4
General government external debt					
Excluding government assets held abroad	4.9	3.5	2.9	2.9	3.0
Including government assets held abroad	2.3	2.0	-0.5	-2.6	-2.1
Money and Credit			Changes in percent		
Base money	27.1	14.6	-9.8	-1.5	14.6
M1	32.1	20.4	19.5	9.3	13.0
Broad money	23.7	25.7	23.0	11.2	10.9
Domestic credit to nongovernment	6.3	30.3	22.2	27.8	27.0
Balance of Payments			In percent of GDP		
Goods and non-factor services balance	-4.6	-3.8	-3.5	-7.1	-8.0
Current account	-4.4	-5.5	-5.6	-10.2	-13.2
Gross international reserves (euro, millions)	852	992	930	958	1107
Exchange Rate					
Exchange rate regime			Currency Board Arrangement		
Exchange rate parity			EEK15.6466=€1		
Real effective exchange rate, end of period, 2000=100 1/	101.9	100.0	101.6	104.9	108.3

Sources: Estonian authorities, and IMF Staff estimates.

1/ From INS, export-share weighted CPI real exchange rate against 15 major trading partners.

Statement by Jon A. Solheim, Executive Director for Republic of Estonia and Tanel Ross, Senior Advisor to Executive Director November 8, 2004

Our Estonian authorities would like to express their appreciation to Mr. Haas and his team for the high quality work and the excellent set of papers. The authorities broadly agree with staff's analysis and recommendations, including on the challenges in the years ahead.

Recent economic developments and prospects

Estonia is in the middle of a broadly based cyclical upturn. The authorities expect the real GDP growth to reach at least 5.8 percent for 2004. Inflation picked up in the second quarter, mostly due to EU accession related factors, including the increase of the excise taxes, but it has subsided from then on. Therefore, the authorities' inflation forecast for 2004 remains unchanged at around 3 percent. The increase in labor productivity will be around 4.5 percent in 2004, up from last year and exceeding the expected 4 percent growth of real wages.

The medium term outlook is favorable with the output growth expected to reach the medium term potential of around 6 percent in 2005. The expansion will be underpinned by investments and acceleration of labor productivity growth. Inflation is projected to stay close to 3 percent both in 2005 and 2006, leaving room for a gradual nominal convergence, while still within the expected margins of the Maastricht criterion. The unemployment rate has declined below 9 percent in 2004, but although the situation in the labor market has gradually improved over the last years, the authorities are aware that the labor participation rate should be increased further if the robust output expansion is to be maintained.

Medium term adjustment of external accounts and credit market developments

The current account deficit has narrowed gradually from mid 2003, supported by a strong export performance. While the EU accession induced a one-off increase in imports and widened the external deficit temporarily in the second quarter, the trade deficit has since resumed a declining trend. The authorities expect the current account deficit to improve somewhat in 2004 as compared to last year. Net factor outflows, mostly reinvested earnings on the inward FDI, will amount to some 7 percent of GDP, more than half of the current account deficit. The inflow of foreign savings has remained robust with the gross FDI flows to Estonia exceeding 9 percent of GDP. As Estonia's investments abroad have increased as well, the net FDI flows will be around 6.5 percent of GDP for 2004, roughly one half of total capital inflows. Intra-group lending by Scandinavian financial conglomerates to their Estonian subsidiaries and branches accounts for most of the remainder. Direct borrowing of enterprises remains subdued.

The rate of credit growth has remained broadly unchanged at around 30 percent. While the expansion of the total household borrowing has decelerated somewhat, its yearly growth is still around 40 percent, with mortgages accounting for 75 percent of the household

debt. On the other hand, the reliance by the real sector on the domestic financial system has increased, as foreign direct borrowing from parent companies has been partly substituted by domestic bank lending. Thus, the modest decrease in the growth of household credit is partly offset by increased lending to enterprises. The financial leverage is still not very high with a household credit to GDP ratio equaling around 20 percent of GDP and the overall bank lending to the real sector amounting to 55 percent of GDP.

Fundamentally, the current account deficit and relatively high credit growth are considered natural at this stage of Estonia's development, reflecting the productivity catch-up and ongoing balance sheet adjustments. Indeed, the authorities welcome staff's balance sheet analysis that provides further evidence of domestic investment being the main factor underlying the current external deficit. Even if the one-off impact of the major infrastructure investments of 2002 and 2003 is gradually subsiding, the private investments are likely to remain strong. On the other hand, the public sector savings and high corporate profitability cannot at this stage fully compensate the households' inter-temporal consumption adjustment, underpinned by increasing productivity, higher incomes and efficient financial intermediation. Against this backdrop, the authorities expect the current account deficit to decline to 9 percent of GDP in 2006 and to around 6 percent of GDP over the medium term.

Macroeconomic policies in 2004 and 2005

The durable convergence with the Euro Area and meeting the Maastricht criteria in a sustainable manner are the overarching policy objectives of the Estonian authorities. The general policy framework remains firmly centered on the currency board and the ERM2 membership. The adjustment of the external position is the main policy concern, as the authorities are aware that the current account deficit cannot be sustained at the present level for long. Therefore, fiscal prudence and a strong financial sector are considered essential for the efficient functioning of the currency board and smooth participation in the ERM2 mechanism. Strong and transparent fiscal and structural policies are also seen as important for the formation of private sector expectations and investment decisions.

Monetary and financial sector policies

Estonia joined the ERM2 framework shortly after the EU accession. During the first four months in the mechanism, the Estonian kroon has not experienced any pressures and the short term interest rate differential against the Euro is negligible. Estonia will maintain its currency board as a unilateral commitment during the ERM2 membership.

The authorities plan to adopt the Euro at the earliest time possible, in accordance with the provisions of the EU treaty. Consequently, their policies on the monetary front are aimed at maintaining an adequate size of banks' liquidity cushions while continuing technical preparations for joining the Eurosystem. The central bank has kept the statutory level of required reserves at 13 percent, but the changes in the calculation of the reserve base - to bring it fully in line with the ECB requirements - resulted in an increase of the effective reserve ratio by 1 percentage point in 2004. Moreover, the authorities are planning the

adoption of the intraday liquidity instrument to increase the efficiency of the banks liquidity management.

The financial system is strong and well capitalized. The consolidated capital adequacy ratio stands close to 12 percent, above the legal minimum of 10 percent, and profitability is solid. Moreover, the share of non-performing loans has declined further to 0.4 percent of the total loan portfolio. Nevertheless, the still rapid credit growth calls for vigilance and the authorities have discussed internally the possible use of prudential ratios for counter-cyclical purposes. However, the outcome of the application of such measures would be suboptimal under the prevailing market structure, as all major financial institutions belong to the Nordic financial conglomerates. More importantly, the authorities have intensified their participation in supervisory cooperation on regional and EU levels.

The authorities are putting emphasis on analyzing the banks' own risk management systems, including in the context of preparing for the adoption of the Basle II framework. Moreover, they remain alert to address possible risks in the real estate and mortgage markets, as the growth of mortgage lending has not only enhanced the supply of new housing, but the prices have increased by 15 percent over the last year as well. Against this backdrop, the banks' lending practices are closely monitored to maintain the loan-to-value ratio broadly at 70 percent for housing loans. The authorities have also reduced by one half the upper limit on households' total tax deductible expenses, including interest payments on mortgages.

Estonia has in place a housing finance support scheme. A specialized governmental agency, Kredex, guarantees for certain groups of the population the initial down payment, typically around one third of the value of the underlying mortgage. The authorities regard this system as an important policy instrument, most notably to support the home ownership among young families. However, they recognize the need to balance the public policies against broader macroeconomic concerns. By October 2004, Kredex had fully used up the statutory limit of 700 million Estonian kroons on its mortgage guarantee portfolio and this proved to be an opportune time to modify the scheme to better target the new entrants to the housing market. The eligibility criteria for applicants were tightened and the maximum amount of a single guarantee reduced by 25 percent. The government decided also to increase the ceiling on the total amount of guarantees by 250 million Estonian kroons, considerably less than initially planned.

Fiscal policy

Estonia continues to adhere to a prudent fiscal stance, commensurate with a fixed exchange rate regime and fully in line with the EU framework. The authorities remain committed to maintaining the general government budget in surplus or balance over the medium term, consistent with the provisions of the Stability and Growth Pact and the EU Treaty.

Against the stronger than projected output expansion, Estonia recorded a significant budget surplus of 2.9 percent of GDP in 2003, mostly accounted for by the functioning of automatic stabilizers. The central government's share in the surplus was allocated partly to

the reserves of the public pillar of the pension system while the other part is set aside for upgrading the public education facilities. As the revenue performance has exceeded projections also in 2004, the government has prepared a supplementary budget to assign some of the expected over-performance to mostly education and environment-related investments. However, this supplementary budget, yet to be approved by the parliament, will add to government spending in 2004 by no more than some 0.2 percent of GDP. The authorities project the fiscal surplus to reach nearly 0.7 percent of GDP for the FY 2004, broadly in line with the cyclical position as the output growth would be slightly below its medium term potential. The amount of fiscal reserves is expected to be around 10 percent of GDP by the end of this year.

The authorities have submitted the FY 2005 budget to the parliament. It is fully balanced on the general government level, in line with the Budget Strategy for 2005-2008 that sets nominal expenditure ceilings for governmental agencies. On the structural front, the authorities will continue the tax reform with a view to decrease the share of direct taxes in the overall tax burden. They intend to decrease the flat income tax rate from 26 to 24 percent in 2005 while containing current expenditures and increasing excise duties, so that the tax reform will be fully financed. Looking forward, the authorities are preparing a comprehensive strategy of tax policies from 2005 to 2009 aiming, among other things, at a lower taxation of labor and the increase of the consumption and environmental taxes.

The local governments recorded a deficit of 0.4 percent of GDP in 2003, fully accounted for by one municipality, the capital city of Tallinn. During 2004, the deficit of municipalities has been reduced to half, as some local governments have reached the legal borrowing limits and, consequently, have contained their spending. The deficit of municipalities is expected not to increase from the current level of 0.2 percent of GDP in FY 2005. To strengthen the budgetary management in the municipalities, the government has prepared a draft Local Governments' Financial Management Act that would, among other things, tighten the limits of deficit and debt, and will introduce a requirement to maintain a liquidity reserve.

As discussed during the 2003 Article IV consultation, the Estonian authorities have established a separate company to manage all real estate holdings of the central government. Consequently, a part of the public investments in structures are recorded by the central government as financial investments in the real estate company, AS Riigi Kinnisvara. The audited accounts of AS Riigi Kinnisvara are publicly available over the internet, and the authorities have consulted with Eurostat to ensure full compliance of their rules with the EU regulations and practices.

Structural policies

The authorities continue to promote an advanced structural reform agenda to support balanced and sustained growth over the medium and long term, including by addressing long term fiscal challenges and by advancing reforms in product and labor markets within the framework of the Lisbon agenda.

The transition to the three-pillar pension system has been successfully completed. The first public pillar is financially sustainable, despite small inevitable transitory costs, and will turn firmly into surplus in a 10 year horizon. Estonia's health care system is based on a universal participation in the Health Insurance Fund and on the system of autonomous private and public service providers. The Health Insurance Fund, financed by the earmarked part of the payroll tax, is financially sound at present. Additionally, the reform of public hospital network is going on in accordance with the Hospital Master Plan 2015, approved by the government in 2003. However, the long term sustainability of the social policy framework depends ultimately on the actual replacement ratios and on the availability of finances to cope with higher medical costs in the future. In this regard, the authorities agree with the conclusions of staff's analysis on Estonia's aging and healthcare expenditures. At the same time, they believe that relatively high fiscal reserves and very low public debt will provide some support in coping with these challenges.

While agreeing with staff that labor market developments have been broadly favorable, the authorities are aware that more needs to be done to increase the employment rate. Further steps in labor market policies include a new draft Employment Contracts Act and an adopted National Action Plan of Employment. While the former is aimed at enhancing the flexibility of contractual relations between employers and employees, the latter will provide more focused services for training of the workforce and will increase the budgetary resources for the implementation of these priorities.

The authorities specified their timetable for the energy sector reform in 2004. In accordance with the EU Directives and provisions governing Estonia's accession to EU, Estonia's energy market will be fully opened for competition by 2012. Meanwhile, the joint stock company owned by major Finnish and Estonian energy suppliers has started the work to connect the Estonian and Scandinavian electric grids, thereby facilitating the gradual integration of Estonia's electricity market to the Scandinavian networks from 2006 and onwards.

Finally, the parliament has adopted a new law to support the voluntary mergers of the municipalities in order to streamline the system of local governments and to reduce their number. Financial incentives to encourage the unifications are provided in the FY 2005 budget. The authorities expect that the strict co-financing rules for use of the EU funds will have a catalytic role in this regard as well.