Republic of Estonia: Selected Economic Indicators

	2001	2002	2003	2004	2005
Real Economy	*In units as indicated*				
Real GDP growth, in percent	7.7	8.0	7.1	8.1	10.5
Average CPI inflation, in percent	5.8	3.6	1.3	3.0	4.1
Unemployment rate (ILO definition), in percent	12.6	10.3	10.0	9.7	7.9
Domestic saving, in percent of GDP	22.9	21.7	21.4	23.6	24.8
Domestic investment, in percent of GDP	28.1	32.4	33.0	36.2	35.2
Public Finance	*In percent of GDP*				
General government balance	0.4	1.1	2.3	1.6	1.6
General government debt					
Excluding government assets held abroad	4.5	5.3	5.7	5.2	4.6
Including government assets held abroad	1.2	0.0	-2.4	-2.8	-3.0
Money and Credit	*Changes in percent*				
Base money	-9.8	-1.5	14.6	24.0	33.0
Broad money	23.0	11.2	10.9	15.8	41.9
Domestic credit to nongovernment	22.2	27.8	27.0	31.2	33.4
Balance of Payments	*In percent of GDP*				
Goods and non-factor services balance	-2.1	-7.1	-7.7	-8.1	-6.2
Current account	-5.2	-10.6	-11.6	-12.5	-10.5
Gross international reserves (euro, millions)	930	958	1098	1317	1647
Exchange Rate					
Exchange rate regime	Currency Board Arrangement				
Exchange rate parity	EEK15.6466=€1				
Real effective exchange rate, end of period, 2000=100 1/	103.4	105.9	109.5	112.1	113.6

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

Statement by Tuomas Saarenheimo, Executive Director for Republic of Estonia and Timo Kosenko, Advisor to Executive Director
November 17, 2006

The Estonian authorities would like to express their appreciation to Mr. Rozwadowski and his team for open and constructive discussions and a set of high quality papers. The authorities agree with most of the assessments and recommendations put forward by staff. In the following, we briefly describe the general macroeconomic situation in Estonia and will focus on the key economic policy challenges thereafter.

General Macroeconomic Situation

Estonia has maintained high GDP growth since the last Article IV discussions and real convergence is well underway, bringing Estonia's real per capita income in PPP-terms to some 70 percent of the EU average by 2007, compared to about 50 percent only four years ago. Over a longer time horizon, high growth rates are sustained by strong productivity improvements, relatively flexible and open economic structures and by strengthened institutional capacity. The authorities share staff's assessment that cyclical factors are also at play and the economy is currently running above its potential. However, output expansion is expected to level off in 2007 and 2008 to 7-8 percent, which the authorities consider as Estonia's medium-term potential.

Against this backdrop, the authorities remain fully committed to strong macroeconomic policies. Estonia's policy framework is centered at the currency board and fixed rate of exchange, supported by tight fiscal policies and flexible markets. The general government budget has been in surplus for five consecutive years and the cumulative surplus for 2002 to 2006 amounts to around 8.6 percent of GDP (13.6 billion EEK). The authorities have prepared the 2007 budget with a view to avoid fiscal loosening and to ensure smooth macroeconomic adjustment. At the same time, the authorities recognize that the key task of fiscal policy, in particular in a small open economy, is to support a stable macroeconomic environment over longer term, and not fine-tune any specific economic indicator. Thus, they agree with staff on the importance of the medium-term budgetary framework.

The authorities note a few specific proposals in the staff report, namely to consider the postponement of the planned cut in the income tax and prioritizing the use of the EU funds with the aim to contain high growth in domestic demand. They emphasize that the income tax reform is an important part of a medium-term structural change in the tax system to reduce the share of direct taxes and is highly prioritized among the policy makers. With the reform being fiscally neutral, the authorities consider it important to complete their key policy commitment. However, they also note that the target of the tax reform was modified somewhat in 2003 and 2005. The uniform income tax rate will be reduced to 20 percent by 2009, instead of the initially planned 2006. Regarding the use of the EU funds, the authorities

are fully committed to make sure that they are employed efficiently and in line with the well-established EU common policies, as also pointed out by staff. To this end, the authorities will adhere to their National Strategic Reference Framework to provide detailed framework in accordance with the Medium Term Budget Strategy. They also note that the allocation of the funds arising from the EU financial perspective for 2007-2013 is in the planning phase, and the authorities take fully into consideration the broader macroeconomic stance, including the projected slowdown in economic growth.

Medium Term Challenges and Competitiveness

Our Estonian authorities agree that maintaining competitiveness and rapid productivity growth remains a key precondition for sustained convergence in the medium- and long-term. Estonia's competitiveness is broadly adequate according to most commonly used indicators, including the REER trends being consistent with convergence developments. However, they note that ULC growth has accelerated recently and the nascent divergence in productivity and real wage growth in the first half of 2006 calls for close monitoring. The authorities take some comfort from Estonia's decent standings in most international comparisons of the business environment, and the Bank of Estonia's recent research also tends to confirm the flexibility in price and wage setting in Estonian companies.

However, further efforts are needed to maintain market flexibility and attractive business climate. The labor market is one of the most important contributors to the economy's long-term competitiveness. In the last couple of years Estonia's unemployment level has rapidly decreased, supported by market flexibility and the structural shift due to the opening up of the EU labor markets. Still the migration of Estonian workers has remained below that from most of the other new EU member states. In the future, further integration of European labor markets may add to labor supply in Estonia as well. From its part, the Estonian labor market is open to the intra-EU labor movement. In addition, the authorities have started discussion on a new Labor Contract Act, which among other changes simplifies the laying-off conditions for the companies. Also, the level of R&D expenditures has grown steadily, and R&D is among the priorities in targeting the EU funds.

Sustained productivity growth and market flexibility are also essential to ensure sustainability of Estonia's external position. At this stage of the long economic cycle, it is inevitable that part of high domestic investment is financed by foreign savings. As Estonia's domestic savings rate of 25 percent of GDP is increasing and economic growth is moving closer to potential, the outlook for the medium-term adjustment remains broadly favorable. Nevertheless, as the overall level of current account deficit is projected to narrow only moderately in the near future, the authorities closely follow external developments. The sustained level of FDI inflows (total FDI stock equals almost 100 percent of GDP) and the fact that the large part of cross-border capital flows takes place within financial groups are mitigating factors to avoid disruption in external financing.

Euro Adoption

Joining the euro area as soon as possible remains a key goal of the Estonian economic policy. With currency board and fixed rate of exchange towards euro in place for almost 15 years already, adoption of the euro is a natural economic policy objective. Estonia continues to fulfill all Maastricht criteria except the inflation criterion. The hike in international oil prices did not allow for reaching the Maastricht inflation criterion in late 2005 and early 2006, since the Estonian consumer basket is almost twice as highly exposed to changes in the world energy prices compared to that in the European Union. More recently, inflation has also been affected by factors related to convergence and cyclical position.

Estonian price developments continue to be very well in line with the equilibrating catching up process, and inflationary expectations are firmly anchored by the currency board framework. However, the recent inflation forecasts render the likelihood of euro adoption in 2008 and 2009 negligible. The authorities note staff's estimates that opportunities exist to reach the Maastricht inflation criterion in the second half of 2008. That would allow joining the euro area in 2010 at the earliest. Current stability and growth oriented policy framework remains the cornerstone in joining the common currency area. The authorities stay vigilant in monitoring closely the risks and market reaction associated with the delay in the euro adoption. Still, recent data indicate that given the continued strong policies, the postponement of the euro adoption has had no material impact on market expectations until now.

Financial Sector and Real Estate Market

The Estonian banking and financial system is fully integrated with the Nordic and international financial conglomerates. Nearly all financial institutions in Estonia operate under risk and liquidity management systems that are uniform across large regional financial groups. The structure of the financial system has had a strong impact on financial intermediation, allowing the mobilization of foreign savings and very substantial intertemporal consumption and investment smoothing. It also provides for virtually unlimited supply of credit, at least in the short-term. At the same time, sustained increase in disposable income has brought along higher demand for credit, in particular for mortgage borrowing. These developments have been accompanied by structural changes in economy and banking, bringing along lower interest rates and longer maturities.

Fundamental changes in the credit market have had their impact on real estate, especially on the housing market activity. In particular, households have made use of consumption smoothing opportunities to improve their living conditions. As a result, apartment prices in Tallinn increased almost 40 percent in 2005. However, in recent months, there are clear signs of cooling: apartment prices in Tallinn have increased on average by only about 10 percent compared to the end of 2005 and the selling periods have lengthened. It is important to