Republic of Estonia: Selected Economic Indicators

	2002	2003	2004	2005	2006
Real Economy		*In units as indicated*			
Real GDP growth, in percent	8.0	7.1	8.1	10.5	11.4
Average CPI inflation, in percent	3.6	1.3	3.0	4.1	4.4
Unemployment rate (ILO definition), in percent	10.3	10.0	9.7	7.9	5.7
Domestic saving, in percent of GDP	21.7	21.4	23.6	24.8	23.3
Domestic investment, in percent of GDP	32.4	33.0	36.2	35.2	38.2
Public Finance		*In percent of GDP*			
General government balance	1.1	2.5	1.6	1.6	3.3
General government debt					
Excluding government assets held abroad	5.6	5.7	5.2	4.4	4.1
Including government assets held abroad	0.3	-2.5	-2.8	-3.1	-5.0
Money and Credit		*Changes in percent*			
Base money	-1.5	14.6	24.0	33.0	30.7
Broad money	11.2	10.9	15.8	41.9	28.2
Domestic credit to nongovernment	27.8	27.0	31.2	33.4	41.6
Balance of Payments		*In percent of GDP*			
Goods and non-factor services balance	-7.1	-7.7	-8.1	-6.2	-10.3
Current account	-10.6	-11.6	-12.5	-10.5	-14.8
Gross international reserves (euro, millions)	958	1098	1317	1647	2128
Exchange Rate					
Exchange rate regime		Currency Board Arrangement			
Exchange rate parity		EEK15.6466=€1			
Real effective exchange rate, end of period, 2000=100 1/	106.8	109.9	113.9	113.3	117.2

Sources: Estonian authorities, and Fund 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
July 23, 2007

Our Estonian authorities would like to express their appreciation to Mr. Rozwadowski and his team for the very constructive and open discussions and the set of high-quality papers. The authorities broadly agree with staff's assessment and value highly the recommendations put forward. In the following, we briefly describe the general macroeconomic situation and focus on the key policy challenges ahead.

General Macroeconomic Situation and Outlook

Estonia has enjoyed high GDP growth over the last years, supported by a strong currency-board arrangement, prudent macroeconomic policies and high competitiveness. Deepening economic and financial ties with the EU have fostered rapid real convergence. However, the authorities agree with staff that the economy is currently running over its potential, owing to buoyant investments and private consumption.

Domestic demand has been reinforced by a very optimistic outlook in the corporate sector and positive expectations of households, bolstered by low unemployment levels. Due to high demand and increases in food prices, inflation has remained at a relatively high level, reaching 5.8 percent in June, compared to the same period last year. Export growth was somewhat lower than expected in the first quarter, mainly because of a decline in transit-related trade flows. However, the direct economic impact of decline in transit is limited, and likely of temporary nature. As very high investment continued to be financed partly by foreign savings and profitability of foreign owned companies was strong, the current account deficit reached 17.9 percent of GDP in the first quarter. At the same time, export growth in the manufacturing sector has been robust, reaching 14.7 percent during the first five months of 2007 showing that competitiveness remains solid.

Over the medium term, growth is set to moderate as demand pressures ease. Tighter lending conditions and higher interest rates have curbed the credit expansion, and the housing market has already started to cool. Selling periods have lengthened, while price increases have slowed and even reversed. Mortgage lending has also clearly decelerated from the beginning of the year. Slowing demand for labor in the construction sector should help to ease the labor market pressures. According to preliminary estimates, the GDP growth slowed to 9.8 percent in the first quarter of 2007. Growth is expected to level off to around 8.5 to 9 percent in 2007 and close to medium-term potential thereafter, broadly in line with staff's projection. The external balance will also gradually strengthen, as the economy steers towards a more stable growth path.

Fiscal Policy

The authorities remain fully committed to strong macroeconomic policies. Underlying Estonia's policy framework is the currency board arrangement, which is supported by firm fiscal policies. The authorities agree with staff that against the background of overheating pressures it is important to maintain a tight fiscal stance. Estonia has continued to accumulate budget surpluses already since 2002, relying on conservative forecasts and setting aside the additional revenues. This has helped to build up sizeable reserves and made the government sector a net creditor, given the very low level of public debt. In its Spring forecast, the Ministry of Finance projected the 2007 fiscal surplus to reach 1.9 percent of GDP; that projection is now expected to be exceeded by a comfortable margin. The authorities agree with staff's advice on avoiding additional fiscal stimulus to the economy and attach high priority to saving any revenue over performance.

The income-tax reform, aimed at shifting the tax system from labor taxation towards consumption and environmental taxation, remains high among the priorities of the government. The income tax rate is scheduled to decrease gradually to 18 percent by 2011. At the same time, rises in excise taxes, some of which are required to harmonize these with the EU levels, are expected to bring additional revenue and, together with expenditure restraint, will ensure that the income tax reform will not result in additional fiscal stimulus.

Looking ahead, the authorities have recently adopted a medium-term budget framework which sets clear priorities and budget targets for the government until the year 2011. The budget strategy is focused on maintaining strong fiscal policies that facilitate smooth economic adjustment and help to meet the fiscal costs related to population aging. To this end, the strategy aims for a continuous budget surplus over the next four years and also establishes targets for expenditure growth, which are set to decline to 6 percent by 2011.

Medium-Term Challenges and Competitiveness

The Estonian authorities agree with staff that, over the medium and long term, productivity advances together with labor and product market flexibility will be essential to maintain competitiveness. As a large share of very high domestic investments is inevitably financed by foreign savings, sustaining the productivity of investments is essential also to ensure a smooth adjustment of Estonia's external position. The real exchange rate has been in line with economic developments, where some appreciation is to be expected during a boom, and does not signal loss off competitiveness.

Against the background of rapid economic expansion and favorable conditions in Estonia's main export markets the enterprises have maintained their competitiveness and increased

profits, despite high wage growth. However, resource and labor constraints have emerged in some sectors. Although the labor productivity growth has historically been broadly in line with wage growth, the authorities agree that recent productivity and real wage developments call for close monitoring. The employment level has shown a healthy increase over the last years, but is expected to level off as the pool of potential workers is limited. Opening of the EU labor market has contributed to a decline in unemployment to very low levels, but also to wage pressures, including in the public sector. In the future, integration with the EU market may increase labor supply, as Estonia's labor market is fully open to workers from the EU, including the new member states.

The authorities have adopted an action plan for economic growth and employment, which identifies measures to increase competitiveness and enhance the flexibility of the labor market. Planned changes to the Employment Contracts Act will streamline the procedures and make firing of workers less onerous for companies, helping to reduce costs and put enterprises in a better position to cope with a potentially less favorable economic environment. The authorities will also start a more comprehensive overhaul of labor legislation, effectively covering all aspects of labor regulation.

Euro Adoption and Inflation

Joining the euro area as soon as possible continues to be a key goal of the Estonian economic policy. The authorities firmly believe that joining the euro area would deepen economic integration, further real convergence and enhance long-term economic stability. The economic policies, relying on flexible markets and conservative fiscal policy are conducive to joining the monetary union. Prudent policies are well established by successfully running a currency board for over 15 years.

Estonia fulfills all the Maastricht criteria, except the inflation criterion. Higher energy and food prices have kept inflation above the reference value, especially as the weight of these components is higher in Estonia's CPI basket than in the EU. More recently, cyclical factors have also been at play and housing related costs have increased. These developments have rendered meeting the Maastricht inflation criterion unlikely before 2010, as the inflation is expected to peak in 2008. However, inflation has been broadly in line with rapid economic growth and continued price level convergence, and is expected to slow along with moderation in economic growth. Nevertheless, the authorities remain vigilant, and monitor closely the market reactions related to postponement of the euro adoption.

In line with staff's advice, the authorities have timed the administrative price increases and measures to harmonize excise duties with EU levels in a manner that limits their inflationary impact on outlying years, when the inflation rate is expected to decline within reach of the criterion. The excise tax rates on cigarettes and tobacco will be increased next year, as well