Estonia-2003 Article IV Consultation
August 1, 2003
Concluding Statement of the Mission

An IMF mission visited Tallinn July 21-August 1 to discuss with the authorities recent economic developments and the government's economic policy agenda for the remainder of 2003 and 2004. This year's IMF consultation mission took place at a time of a less sanguine global environment and increased external vulnerability of the Estonian economy-and at a time when the country is preparing itself for EU membership.

While Estonia's growth and inflation outlook continues to remain positive, weaker than expected global demand contributed to a slight downward revision of the staff's growth projections. We now expect the Estonian economy to grow by 4.5 percent in 2003. However, with an expected improvement in demand conditions in the Euro area next year, increasing inflows of EU grants, and assuming a positive outcome of the EU referendum, economic growth is projected to reach 5.5 percent in 2004. While some positive factors, such as lower food prices, contributed to an improved inflation forecast for the current year, inflation is expected to accelerate-largely as a result of an increase in excise taxes as a result of EU tax harmonization and strong demand conditions in the Euro area-from a projected average rate of 1.1 percent in 2003 to 3.0 percent in 2004.

As in the past, our policy discussions with the authorities have been very productive and extremely cordial. The discussions focused primarily on the rising external imbalances as reflected in the large current account deficit. According to our projections, the current account deficit could reach 12.8 percent of GDP in the current year and remain at a high level in 2004. Our concern is that buoyant conditions have led to a current account that cannot be sustained over the longer term. Reinforcing this view is the fact that, unlike in the past, the current account is not fully financed by foreign direct investment and is now to a larger degree financed by debt, something we expect to continue.

However, due to the currency board arrangement, the tools for corrective policy actions are largely limited to fiscal policy. Unlike in countries that have a flexible exchange rate system, an adjustment of the current account through a depreciation of the exchange rate is not an option. Therefore, we urge the authorities to avail themselves of the one policy tool at their disposal and tighten fiscal policy. This will both alleviate pressure on the current account and send an important signal to markets that the authorities are, indeed, pursuing a prudent fiscal policy. In particular, we urge the authorities to let automatic stabilizers operate fully and to postpone some of the planned spending increases for the second half of 2003. To ensure a positive impact on expectations of market participants, the authorities should announce a fiscal target greater than the surplus achieved in 2002 (when it was 1.2 percent of GDP); in our view, the target should be on the order of 2 percent of GDP. As a first, immediate step, the government should reassure markets that it does not intend to pass a second supplementary budget that would increase expenditures any further this year.

In addition, we encouraged the government to change its current fiscal target, by adopting a target that would balance the budget over the business cycle rather than on an annual basis. In our view, any country should balance its budget over the business cycle in order to stabilize growth. But, given the currency board, this is particularly important in Estonia and means running a surplus when growth is strong-as it is now-and a deficit when the economy needs additional stimulus.

In our view, the policy initiatives for 2004 and beyond-such as the increase in parents' benefits and tax reform-could easily undermine the government's objective of balancing the budget. The Ministry of Finance has drafted a balanced budget that is predicated on a large increase in receipts of EU funds and the need for Ministries to strongly limit expenditure growth. We are particularly concerned that the assumptions regarding EU grants are overly optimistic. Past experience in Estonia and other accession countries shows that the capacity to absorb all available EU funds is limited, and it is not clear how the budget will be balanced if there is a shortfall in receipts. While we commend the government for wanting to lower the income tax and are sympathetic to the government's policy initiatives to stem the fall in population, we urge the government to postpone some of the measures to ensure that they are consistent with a balanced budget. In particular, we are concerned that without an

overall spending cap, the cost of parents' benefits might substantially exceed projections. In order to balance the budget, the mission also discussed with the government other possible measures such as the elimination of the tax deductibility of mortgage interest payments, the elimination of the tax exemption on interest income from bank deposits, and an increase in the value-added tax (VAT). It is also important that the increased EU grants be spent effectively, especially in agriculture where they should be used to increase productivity and not used simply to provide passive income support.

We are also concerned that fiscal policy is becoming somewhat less transparent in Estonia, which could undermine the credibility of the government. Estonia's past performance and advanced standing among all EU accession countries is-among other things-directly related to its prudent and easily understood fiscal policies. However, one of the mission's findings is that the government may be taking its own stated fiscal objectives less seriously. The increase in government spending via the purchase of equity in a publicly-owned real estate company gives the appearance of having been driven by the objective of not increasing the fiscal deficit, as does operational leasing by municipalities. It has taken Estonia a decade to achieve a record for fiscal transparency that is the envy of the world; it would be a shame if this is lost.

Finally, we caution against changing the current pension indexation formula as this would jeopardize the long run sustainability of the pension system. Furthermore, we urge the authorities to offset any increase in pensions with countervailing measures such as an increase in the statutory retirement age.

We recognize and support the actions of the Bank of Estonia to curtail the strong credit growth through measures such as moral suasion and the increase of the base for reserve requirements. However, we encourage the authorities to monitor credit growth closely and to be prepared to increase prudential lending requirements temporarily on a selective basis, if necessary, to ensure the continued health and stability of the banking system.

We discussed with the authorities a number of measures related to the harmonization of the monetary policy framework to that in the EU and agree with the BOE that a reduction of reserve requirements should only take place if, and when, macroeconomic and monetary conditions warrant such a change. However, we encouraged the authorities to move forward in establishing an intra-day lending facilities. Furthermore, we fully support the authorities objective in adopting the Euro at the earliest possible date.

Estonia has been remarkably successful in implementing good policies that have led to the successful transformation of the economy, strong growth, and a stable price level. For this the authorities are to be commended. We urge them to continue on this path and not to become complacent.