International Monetary Fund
2008 Article IV Consultation for Estonia
Conclusions of the Mission

1. **The Estonian economy is undergoing its first significant slowdown in nearly ten years.** The turnaround was caused by a shift in sentiment as EU accession-related euphoria gave way to more realistic expectations, and by a reversal of credit conditions as cheap global credit gave way to cautious lending at higher interest rates. Domestic demand slowed and the external current account deficit narrowed sharply. The slowdown was needed – it was preceded by two years of unsustainable high growth and wide imbalances – but it is now proceeding faster than expected. Indeed last week's surprisingly low flash estimate of first quarter 2008 GDP suggests that growth for the year as a whole may be negative.

2. **The labor market and inflation have yet to respond.** There have been layoffs in some sectors – notably construction – but overall employment continued to rise in the first quarter of 2008 and wage growth is still close to the peak attained last year. The still tight labor market, combined with soaring food and energy prices and increases in excise taxes, has driven inflation above 10 percent.

3. **At the present juncture the challenge facing the economy and policymakers is to support the resumption of growth while containing inflation and external imbalances.**

4. **A recovery of growth will depend in large part on the competitiveness of the economy.** Consumption is likely to remain subdued because households are saving to build financial buffers in light of increased economic uncertainties. Therefore, a revival of exports or investment will be needed to prime the pump for a recovery. For investment growth to resume, and exporters to be competitive in relatively sluggish global markets, wage growth should be consistent with productivity gains – not higher, as in the past two years. The uncertain economic outlook and reduced firm profitability create conditions for wage growth to slow. However, the timing of this adjustment is unclear.

5. **Assuming no further external price shocks, inflation should moderate in 2009**. The currency board arrangement will continue to provide the key anchor to prices and price expectations. In addition, the impact of the 2008 increases in administrative prices and excises will recede, while the economic slowdown should dampen demand-related pressures.

6. **While the narrowing of the current account deficit is welcome, external imbalances remain a source of vulnerability**. The large stock of external liabilities and banks' dependence on funding from abroad are sources of risk, particularly in the context of a less favorable climate in international financial markets. The current account deficit is still estimated to be larger than warranted by medium term factors such as demographic trends and the convergence of per-capita income towards the EU average – though the magnitude of the gap is subject to significant uncertainty. For the period ahead, it will be important for the current account deficit to narrow further and for external competitiveness to improve.

Fiscal policy

7. **Fiscal policy needs to strike a balance between reversing past slippages in the fiscal position and supporting demand during the current downturn.** The strong fiscal outcomes of the last two years mask large increases in current expenditure (40 percent over the past two years) that were covered by exceptionally high revenues related to the economic boom. Further increases this

year resulted in an expansionary budget and, with the economy slowing, the fiscal outcome is headed for a negative balance. Under these circumstances, the authorities' commitment to "balance or better" thus calls for tightening. On the other hand, significant downside risks to growth argue for allowing fiscal stabilizers to work.

8. **The authorities' proposals for 2008 strike a balance between the two objectives.** The recently approved supplementary budget introduces adjustments that reduce the projected deficit while leaving a positive fiscal impulse to cushion the slowdown. The authorities have indicated that they will take further steps – if needed – to balance the budget. The quick response to the budget gap testifies to their commitment to prudent fiscal management. The mission supports the intention to find further fiscal savings, but not at any cost. Savings should not offset all of the positive impulse and should not be implemented by cutting investment, especially that co-financed by the EU, which is needed to support the resumption of growth.

9. **To correct for past policy slippages, the fiscal position should be strengthened over the medium term.** In this context, the government's proposal to freeze the state budget wage bill for the next two years is a welcome first step and should be extended to other levels of government. The freeze would create incentives to eliminate inefficiencies in government. It would also send a strong signal for wage moderation in the private sector. More broadly, the mission welcomes the authorities' intention to review expenditure and revenue policies in the medium term budget framework with an eye to identifying savings. Priority should be given to savings that lead to a more efficient allocation of resources.

Financial sector policies

10. **The banking sector will be tested by the slowdown.** While the system is currently well capitalized (in part due to regulatory requirements), banks' profitability will be challenged by rising non-performing loans and slower loan growth stemming from the economic slowdown. In addition, the banking sector is vulnerable to increases in global interest rates. These vulnerabilities call for heightened supervisory vigilance and additional supervisory resources.

11. **In view of the turbulence in international financial markets last year, the Estonian authorities are wisely exploring measures to strengthen their financial safety net.** Given the structure of the financial sector, and its importance to economic growth, we encourage these efforts. Also, as is true for many other countries whose financial systems are dominated by foreign-owned banks, there is a need for Estonia and its Baltic and Nordic neighbors to further enhance cooperative efforts in building a sound safety net and general crisis preparedness frameworks.

Structural policies

12. **Labor market flexibility facilitates the reallocation of resources and supports competitiveness**. Decentralized wage setting, high rates of labor turnover, and the prevalence of performance-based bonuses have all contributed to labor market flexibility in Estonia. The draft labor contract law recently agreed between social partners would go a long way to address the residual labor market rigidities. Consideration could be given to its early adoption and implementation.

Tallinn
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