COUNCIL OPINION

of 4 March 2008

on the updated convergence programme of Estonia, 2007-2011

(2008/C 73/04)

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies ([1]), and in particular Article 9(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On 4 March 2008, the Council examined the updated convergence programme of Estonia, which covers the period 2007 to 2011.

(2) The Estonian economy is slowing after a period of very rapid growth related to, inter alia, high credit growth and overall accommodative monetary conditions that fuelled a consumption and housing boom. During this period significant macroeconomic imbalances have emerged, with labour shortages having recently contributed to the emergence of a wage-price spiral and wage growth having outpaced that of productivity, leading to worsening cost competitiveness.

Estonia's fiscal policy, which has particular importance given the constraints of the monetary policy regime, has been overall sound with budget surpluses since 2002 and low government debt. However, a tighter fiscal stance could have done more to counter the overheating tendencies of the economy and to correct the macroeconomic imbalances. These imbalances are expected to moderate only gradually in coming years, with continuing tight labour market conditions, wage growth in excess of productivity growth, price pressures and persistent, albeit somewhat diminishing, external imbalances. The deceleration path is thus surrounded by downward risks, though these are mitigated by the high degree of flexibility that the economy has hitherto demonstrated.

(3) The macroeconomic scenario underlying the programme envisages that real GDP growth will moderate from 7,5 % in 2007 to 5,25 % in 2008 and 6,5 % on average over the rest of the programme period. Assessed against currently available information ([2]), this scenario appears to be based on cautious growth assumptions for 2008 and plausible growth assumptions thereafter. The programme projects inflation to rise to 8,5 % in 2008 and remain high at 5,5 % in 2009, which appears realistic in the light of the recent surge in food prices and likely administered price increases. These projections show that Estonia will be making only limited progress towards nominal convergence. The external deficit is expected to narrow in line with the weakening of domestic demand growth from 14 % of GDP in 2007 to around 10 % in 2009 and around 8 % thereafter; this is plausible, but subject to the risk that worsening cost competitiveness hampers this improvement.

([1]) OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text can be found at the following website:
http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm

([2]) The assessment takes into account notably the Commission services' autumn forecast and the Commission assessment of the October 2007 implementation report of the national reform programme.

(4) For 2007, the general government surplus is estimated at 2,6 % of GDP in the most recent update of the convergence programme, against a target of 1,2 % of GDP set in the previous update. The better outcome, expected also in the Commission services' autumn forecast, is largely determined by the carry-over of the better-than-expected outcome in 2006 and to a lesser extent by significantly higher-than-expected revenue growth more than offsetting markedly higher-than-budgeted expenditure growth. Budgetary implementation in 2007 was partly in line with the invitation in the Council opinion of 27 February 2007 on the previous update of the convergence programme ([1]). Although the budgetary surplus appears to be higher than planned, the structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) is expected to have deteriorated compared with the previous year by above 0,5 percentage point of GDP, implying a pro-cyclical stance in good times. Moreover, the increase of expenditure via the supplementary budget adopted in December 2007 was inconsistent with fostering macroeconomic stability and the correction of the external imbalance.

(5) The main goal of the programme's medium-term budgetary strategy is to foster macroeconomic stability and long-term sustainability of public finances by keeping the fiscal position in surplus and thus overachieving the medium-term objective (MTO), defined as structural balance. The general government headline surplus is expected to decline from 2,6 % of GDP in 2007 to 1,3 % in 2008 and subsequently to around and just below 1 % in the outer years of the programme. The structural balance calculated according to the commonly agreed methodology will decrease from 1,25 % of GDP in 2007 to 0,75 % in 2008 and increase again to 1,25-1,5 % of GDP beyond 2008.

Compared to the previous update of the convergence programme, fiscal targets have been confirmed for 2008 and lowered by around 0,5 percentage points of GDP for subsequent years, against the background of a downward revision of economic projections and an upward revision of the inflation forecast. General government revenues relative to GDP are expected to decline by about 1 percentage point over the programme period, driven primarily by a lower share of taxes on income and wealth due to gradual reductions in the income tax rate. Expenditures are expected to increase by about 1 percentage point over the programme period, with the largest impact arising from an increase in social payments, in particular pensions due to the adoption of a more generous indexation rule.

(6) The risks to the budgetary projections in the programme appear broadly balanced. On the one hand, the programme's macroeconomic assumptions are cautious for 2008, with the possibility that the budgetary outcome proves better than expected in the programme. The programme provides detailed information on envisaged revenue measures and tax projections seem plausible. On the other hand, despite an overall strong track record, there has been a practice in recent years to direct part of higher-than-expected revenues to increasing expenditures through supplementary budgets, thus not respecting set expenditure targets. If the economic slowdown proves to be more severe and/or protracted than in the programme scenario, this would also lead to less favourable public finances. In particular, were the credit-financed, domestically driven rapid growth of the Estonian economy to slow abruptly, or the composition of growth to change considerably towards a less tax-intensive growth pattern, the budget could come under pressure.

(7) In view of this risk assessment, the budgetary stance in the programme seems sufficient to maintain the MTO with a good margin throughout the programme period, as envisaged in the programme. However, the deterioration of the structural surplus in 2008 amounts to a fiscal expansion, which carries a risk that the fiscal policy stance implied by the programme may turn out to be pro-cyclical if the economy continues to grow at high rates. This would not be in line with the Stability and Growth Pact. Furthermore, at this stage of the cycle, when the economy has started to decelerate but substantial macroeconomic imbalances still persist, fiscal policy should avoid aggravating those imbalances.

(8) Estonia appears to be at low risk with regard to the sustainability of public finances. The long-term budgetary impact of ageing is among the lowest in the EU and should remain so according to the programme, even taking into account the effect of the recent change in the pension indexation rule. The current level of gross debt is very low in Estonia and maintaining sound government finances, in line with the budgetary plans over the programme period, would contribute to limiting the risks to the long-term sustainability of public finances.

([1]) OJ C 72, 29.3.2007, p. 5.

(9) The convergence programme seems to be consistent to some extent with the October 2007 implementation report of the national reform programme. In particular, the fiscal policy measures and the revision of the pension system, which have been announced in the NRP, are comprehensively assessed in the update convergence programme. However, a qualitative assessment of the overall impact of the national reform programme within the medium-term fiscal strategy is lacking. In addition, information on the direct budgetary costs and savings as well as projections associated with the main reforms envisaged in the NRP appear only partly provided, notably those on measures with a more microeconomic or employment-related character like R&D expenditure, lifelong learning, vocational education and active labour market policies.

(10) Securing an orderly return to a balanced convergence path and ensuring continued smooth participation in ERM II requires determined policy efforts. Upon entry into the mechanism, Estonia undertook commitments related to fiscal, financial sector and structural policies. Fiscal performance has been overall strong in the ERM II period, although the recent fiscal stance was not particularly ambitious given the initial position and stage of economic cycle, possibly having resulted in pro-cyclicality in 2007. Reserve and prudential requirements have been tightened to help contain rapid credit growth, but the direct impact on lending growth appears to be limited. Wage growth has picked up strongly in the private sector and was followed by the public sector in the context of rapid economic growth and a tight labour market and currently represents the main challenge for the Estonian economy. Estonia planned measures to increase labour market flexibility in the NRP and has recently committed itself to introduce further measures to improve economy-wide productivity.

(11) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme has some gaps in the required and optional data [1].

The overall conclusion is that the programme aims at maintaining a sound budgetary position throughout the period with continued, albeit somewhat declining, surpluses above the MTO. The budgetary targets seem plausible. Macroeconomic imbalances that have accumulated in the economy during the years of high growth, notably wage growth exceeding that of productivity, price pressures and high net borrowing *vis-à-vis* the rest of the world, are expected to moderate only gradually and the deceleration path of the economy is surrounded by downwards risks. Setting budgetary strategy that aims at overachieving the MTO is a step forward in addressing these macroeconomic challenges. Nevertheless, fiscal policy in 2007 appears to have been pro-cyclical and risks remaining so also in 2008 if the Estonian economy continues to grow at high rates. It would be desirable to maintain a broadly neutral fiscal stance in 2008, as it would support adjustment in the current phase of the cycle when imbalances accumulated during the period of very high growth still persist. The long-term sustainability of public finances is assessed to be at low risk.

In view of the above assessment and also given the need to ensure sustainable convergence and a smooth participation in ERM II, Estonia is invited to contribute to reducing risks to macroeconomic stability by:

(i) aiming for a neutral fiscal stance in 2008 and beyond so as to contribute to an orderly adjustment towards a balanced convergence path;

(ii) complementing the recommended fiscal stance with ensuring appropriate public wage policy and further labour market reforms as well as sustaining rapid productivity growth so as to contain inflationary pressures.

Comparison of key macroeconomic and budgetary projections

		2006	2007	2008	2009	2010	2011
Real GDP (% change)	**CP Nov 2007**	**11,2**	**7,4**	**5,2**	**6,1**	**6,7**	**7,0**
	COM Nov 2007	11,2	7,8	6,4	6,2	n.a.	n.a.
	CP Dec 2006	*11,0*	*8,3*	*7,7*	*7,6*	*7,5*	*n.a.*

[1] In particular, nominal effective exchange rate assumptions are missing. In addition, assumptions for euro area interest rates are used, although this can be justified by the absence of sufficiently representative EEK interest rate indicators in Estonia.

		2006	2007	2008	2009	2010	2011
HICP inflation (%)	**CP Nov 2007**	**4,4**	**6,6**	**8,6**	**5,6**	**3,6**	**3,5**
	COM Nov 2007	4,4	6,3	7,3	4,8	n.a.	n.a.
	CP Dec 2006	*4,4*	*4,3*	*4,4*	*3,5*	*3,2*	*n.a.*
Output gap (1) (% of potential GDP)	**CP Nov 2007**	**3,6**	**2,7**	**0,1**	**– 1,2**	**– 1,5**	**– 1,3**
	COM Nov 2007 (2)	2,9	2,1	0,1	– 1,7	n.a.	n.a.
	CP Dec 2006	*2,0*	*1,2*	*0,2*	*– 0,3*	*– 0,7*	*n.a.*
Net lending/borrowing *vis-à-vis* the rest of the world (% of GDP)	**CP Nov 2007**	**– 13,2**	**– 14,0**	**– 9,9**	**– 8,2**	**– 7,8**	**– 7,4**
	COM Nov 2007	– 11,9	– 13,6	– 11,2	– 9,6	n.a.	n.a.
	CP Dec 2006	*– 10,2*	*– 11,5*	*– 9,9*	*– 8,9*	*– 7,2*	*n.a.*
General government balance (% of GDP)	**CP Nov 2007**	**3,6**	**2,6**	**1,3**	**1,0**	**0,9**	**0,8**
	COM Nov 2007	3,6	3,0	1,9	1,0	n.a.	n.a.
	CP Dec 2006	*2,6*	*1,2*	*1,3*	*1,6*	*1,5*	*n.a.*
Primary balance (% of GDP)	**CP Nov 2007**	**3,7**	**2,7**	**1,4**	**1,1**	**1,0**	**0,8**
	COM Nov 2007	3,7	3,1	2,1	1,1	n.a.	n.a.
	CP Dec 2006	*2,8*	*1,4*	*1,3*	*1,7*	*1,6*	*n.a.*
Cyclically-adjusted balance (1) (% of GDP)	**CP Nov 2007**	**2,5**	**1,8**	**1,3**	**1,4**	**1,3**	**1,2**
	COM Nov 2007	2,7	2,4	1,9	1,5	n.a.	n.a.
	CP Dec 2006	*2,0*	*0,8*	*1,2*	*1,7*	*1,7*	*n.a.*
Structural balance (3) (% of GDP)	**CP Nov 2007**	**1,8**	**1,2**	**0,8**	**1,4**	**1,3**	**1,2**
	COM Nov 2007	2,2	1,8	1,4	1,5	n.a.	n.a.
	CP Dec 2006	*1,4*	*0,4*	*1,2*	*1,7*	*1,7*	*n.a.*
Government gross debt (% of GDP)	**CP Nov 2007**	**4,0**	**2,7**	**2,3**	**2,0**	**1,8**	**1,6**
	COM Nov 2007	4,0	2,8	2,3	2,0	n.a.	n.a.
	CP Dec 2006	*3,7*	*2,6*	*2,3*	*2,1*	*1,9*	*n.a.*

Notes:

(1) Output gaps and cyclically-adjusted balances from the programmes as recalculated by Commission services on the basis of the information in the programmes.

(2) Based on estimated potential growth of 8,8 %, 8,7 %, 8,4 % and 8,1 % respectively in the period 2006-2009.

(3) Cyclically-adjusted balance excluding one-offs and other temporary measures. One-offs and other temporary measures are 0,7 % of GDP in 2006, 0,6 % in 2007 and 0,5 % in 2008; all surplus-increasing according to the most recent programme, of which the Commission services consider 0,2 % of GDP in 2006 not to be of a one-off nature.

Sources:

Convergence programme (CP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations.