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Highlights in this issue:

- Strong domestic demand, supported by high credit growth, drives up Estonia's external deficit
- Currency board is not at risk, but the external deficit heightens vulnerability
- Continued policy discipline is required to support an orderly correction

Estonia's external deficit: a sign of success or a problem?

By Paul Kutos and Helga Vogelmann***

Summary

Estonia has successfully mastered the transition from a planned to a market economy. It has established a rather liberal economic regime, flexible labour markets and a business-friendly environment. At the same time, it has achieved a high degree of macroeconomic stability, supported by a sound fiscal policy. Estonia joined ERM II in June 2004, maintaining its currency board arrangement as a unilateral commitment. Average growth between 2000 and 2004 was 6.5% per year, while estimated potential growth is even higher. The main macroeconomic imbalance is a high external deficit. Although this largely reflects strong investment needs in the catching-up process, public savings will continue to be required as an important counterweight to low and declining household savings. This article looks at the main underlying factors driving Estonia's external imbalance and provides some reflections on sustainability issues, as well as on the role of fiscal policy. It concludes that Estonia's external deficit does not reflect fundamental imbalances that would require drastic policy reversals, but that it does nevertheless increase the economy's potential vulnerability to unfavourable external developments.

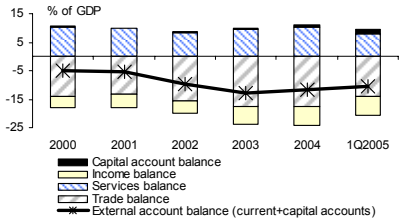
A rapid expansion of the external deficit...

The external account deficit has widened rapidly since 2002…

After hovering around 5½% of GDP in 2000 and 2001, Estonia's external account deficit[1] surged to nearly 10% of GDP in 2002. In 2003, it peaked at 12.7% of GDP, and remained high at 11.8% of GDP in 2004. The trade deficit weakened to over 17% of GDP both in 2003 and 2004. This was partly compensated by an increasing surplus on the services balance, while the deficit on the income balance kept rising. A gradual narrowing of Estonia's external account deficit has been forecast for some time, and finally appears to have set in late 2004, primarily through the trade balance, as exports picked up strongly. The Commission services spring 2005 forecast projects a reduction of the external deficit to below 10% of GDP by 2006, whereas recent developments during the first quarter of 2005 suggest a more rapid correction.

…but started to narrow significantly in the first quarter of 2005

Chart 1: Composition of external account



Source: Bank of Estonia, European Commission services

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Looking beyond Estonia's borders, widening external account deficits have also become a familiar feature in the fast-growing Baltic neighbour states Latvia and Lithuania, whose real growth rates are even higher than Estonia's, at 8.5 and 6.7% respectively in 2004. External account deficits in 2004 stood at 11.6% of GDP in Latvia, and 7% in Lithuania, both on a rapidly increasing trend.

...raised questions about its sustainability

Huge investment needs during transition cannot be financed by domestic savings alone

The pronounced deterioration of Estonia's external balance since 2002 has raised concerns of both short-term vulnerability and medium-term sustainability. Nevertheless, there is widespread agreement among academics and policy-makers that, for a certain period, sizeable external account deficits tend to occur in transition economies, in view of their low capital stock and ample investment opportunities that cannot be financed by domestic savings alone. Also, the path of consumption will adjust to enhanced income expectations, and pent-up demand (e.g. for housing) can be released as financial deepening progresses. From this perspective, the existence of temporarily high external deficits reflects rational choices by economic agents, whose behaviour is consistent with fundamentals and even beneficial for sustainable long-run growth, for example by supporting the economic catching-up process (assuming that economic agents do not exhibit "irrational exuberance" on profit and income prospects which would eventually have to be corrected).

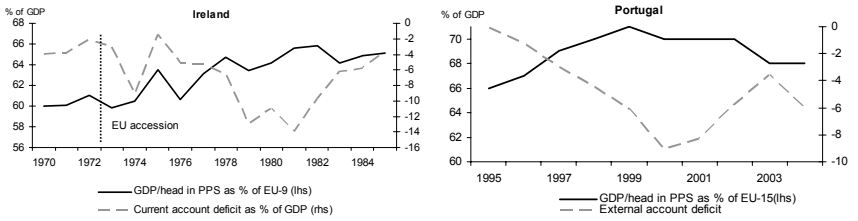
'Safe' deficit levels are assumed to lie in the range of 5-7% of GDP

The possibility to determine a country's "sustainable" current account position with any degree of precision is limited, in particular in very small, open economies like Estonia. Attempts to quantify sustainable external account positions in transition countries point to "safe" deficits during the catching-up period in the order of 5-7% of GDP. Using a variety of methods, the IMF estimated in 2003 that, for the Baltic countries, current account deficits of around 7½% of GDP would appear to be in line with medium-term sustainability, while in the longer term, sustainable deficit levels would be in the order of 5% of GDP (IMF, 2003). This assessment is broadly consistent with the findings of a more recent ECB study[2], and is shared by the Estonian authorities. The question is thus whether a further orderly correction of the external deficit towards a more sustainable level can be anticipated under a continuation (or strengthening) of present policies.

Ireland, too, experienced a short but pronounced external deficit while catching up

In this context, it might be useful to look for historical evidence. Ireland, which often serves as a reference model for Estonian policy-makers, also experienced a short but pronounced dip into a double-digit current account deficit. Given the uniqueness of the transition process from planned to market economies in the new Member States from Central and Eastern Europe such a comparison requires some qualification. Nevertheless, it may help to better understand the issue in the specific context of an economic environment characterised by high investment and rapid restructuring.[3] In Ireland's case, this phenomenon turned out to be temporary. However, as the more recent case of Portugal shows, high external account deficits can also become entrenched. This is true in particular if the underlying reasons for the deficit do not lie primarily with investment and catching-up dynamics, but rather are triggered by a consumption boom related to euro adoption.

Chart 2: High current*/external account deficits in Ireland and Portugal



** Ireland: no historical capital account data; current account related to EU-9 as approximation. Data are therefore not fully comparable.*

Source: European Commission services, Eurostat

The driving factors are manifold

Strong domestic demand and high outflows of income are dominant factors

The sharp widening of Estonia's external account deficit in 2002 occurred on the back of surging domestic demand growth, while in 2004 an increased import content of domestic demand appears to have played a major role. Real domestic demand growth slowed from 9.3% and 9.9% in 2002 and 2003 respectively to 5.5% in 2004. At the same time, gross fixed capital formation in real terms kept growing more rapidly than real GDP. Given the high import content of investment, this has strongly impacted on the external account.

Sizeable income outflows account for an increasing share of the deficit

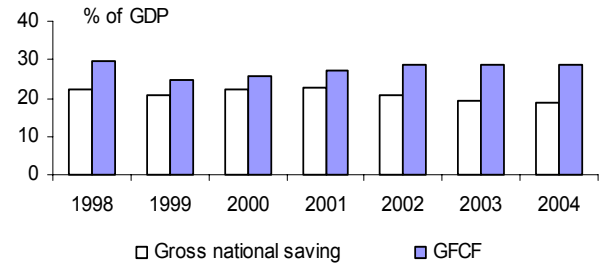
Sizeable net income outflows, resulting primarily from healthy profits of foreign-owned firms, also accounted for a significant share of external account deficits, amounting to over 6% of GDP in both 2003 and 2004. However, currently about three-quarters of outgoing profits are re-invested in Estonia, which is at least partly due to a tax exemption for reinvested earnings. They are registered as FDI (foreign direct investment) inflows in the financial account and thus reduce the country's external net financing requirement. This may alleviate short-term concerns about the size and sustainability of Estonia's external net deficit, but at the same time it highlights the importance of preserving a supportive investment climate and keeping investor sentiment favourable.

The domestic savings–investment balance in Estonia has also been affected by buoyant consumption growth. This can be interpreted from an inter-temporal optimisation perspective, as households engage in consumption smoothing in view of an upward shift in permanent income expectations. At the same time, low interest rates and financial deepening have eased access to credit. Consequently, household debt, incurred to finance both consumption (particularly of durable goods) and investment (mainly in real estate), quadrupled between 2000 and 2004, although, at a little above 25% of GDP, it is still at a relatively modest level by international standards.

The domestic savings–investment balance has deteriorated

Against the background of lower household saving, the ratio of overall domestic savings to GDP decreased sharply by some 5 percentage points between 2001 and 2003 to around 18% of GDP. Increased government sector saving has so far partly compensated for the significant downward trend in private savings, underlining the key stabilising role of prudent fiscal policy and illustrating the risks posed by any slackening in the budgetary stance. At the micro level, effective financial supervision will also be important in order to contain the risks stemming from strong credit growth to households. Estonia's record in this respect so far has been sound.

Chart 3: Savings and Investment



Source: Bank of Estonia, Eurostat

As to the outlook, on the one hand consumption growth has moderated since 2003, remaining below real GDP growth. This should allow the private savings ratio to recover somewhat, but only gradually and from low levels. On the other hand, credit conditions are expected to remain favourable to borrowing over the near future. The recent housing boom appears to be cooling off since EU accession, but is far from over. The second-pillar pension scheme introduced in 2002 (compulsory for new labour market entrants, with more than half of the labour force already participating) may induce an increase in household savings. However, since Estonian pension funds are primarily invested in foreign assets, these savings at the same time tend to weaken the financial account surplus that is financing the external deficit, while inflows can be expected on the income balance. In the short term, the corporate sector, with increasing profits, a lowering tax burden and recovering exports, can

reasonably be expected to bolster domestic savings, whereas households are expected to start saving again only in the medium term. To some degree, the government sector can also be expected to continue to underpin domestic savings, although the new government that recently took office looks likely to use the fiscal room for manoeuvre for social expenditure. High fiscal surpluses therefore look likely to give way to a balanced position in the near future.

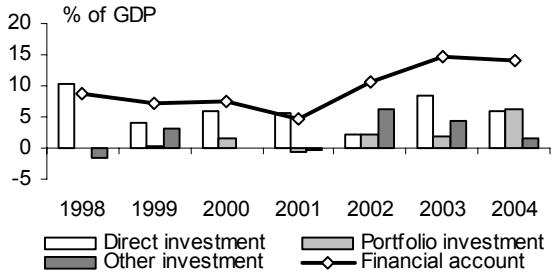
How is the deficit financed?

External financing conditions are favorable

Estonia has encountered no difficulties in financing its large external deficit, reflecting positive investor sentiment towards the country's situation and outlook. External account financing is supported by sizeable FDI inflows, though they have been somewhat volatile in recent years. The main source of Estonia's FDI is the Nordic countries, with Sweden and Finland together accounting for some 70% of inward FDI stocks. In 2000 and 2001, net FDI inflows amounted to some 6% of GDP, fully financing the external account deficit. After a marked deceleration in 2002, net FDI inflows recovered strongly in 2003 and remained high in 2004, at 6% of GDP (i.e. somewhat more than 50% of the external account deficit). More than 70% of direct investment into Estonia was accounted for by re-invested earnings, which constitutes a strong increase from 2003 when the figure was already a respectable 54%. In the medium term, the Estonian authorities expect FDI inflows to stabilise at some 4½-5% of GDP, based on a favourable investment climate and high growth potential.

The widening external deficit has driven up Estonia's external debt

Chart 4: Financial account and its components

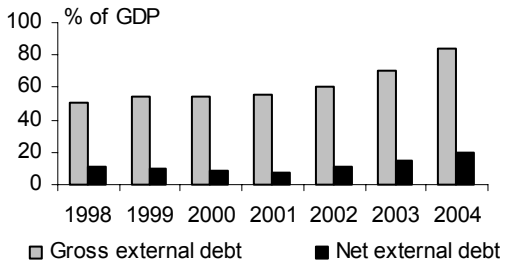


Source: Bank of Estonia, Eurostat

Portfolio and other investment play only a secondary role and are highly volatile

In contrast, portfolio flows play only a secondary role for Estonia, with year-on-year developments highly volatile. This can mainly be attributed to the small size of the Estonian financial market, where individual transactions (e.g. bond issuance for specific projects) strongly influence the overall balance. A dominant element in the balance of payments item "other investment" is intra-group bank financing, i.e. loans and deposits from Nordic parent banks to their Estonian subsidiaries, for on-lending to their domestic customers. The importance of this mode of financing reflects the fact that most of Estonia's banking sector is owned by strategic foreign investors. The extremely narrow creditor base decreases the country's vulnerability vis-à-vis abrupt shifts in market sentiment, while it increases the banking sector's exposure to adverse developments affecting parent banks.

Chart 5: Gross and net external debt



Source: Bank of Estonia, Statistical Office of Estonia (ESTAT)

Despite the significant share of non-debt-creating capital inflows, the widening external account deficit has driven up Estonia's external debt. While gross external debt has increased from 60% to more than 80% of GDP in the last two years, net debt remains relatively low, though also on a rising trend. Foreign liabilities are

mostly denominated in euro, which mitigates the exchange rate risk, given the stable currency board maintained within ERM II. Nonetheless, these debt developments warrant close monitoring, since just by virtue of their size, large net inflows have the potential for disruptive volatility which might also impinge on the credibility of the monetary arrangement. However, some features of inflows to Estonia – including the large share of FDI and the role of economic fundamentals in attracting them – should continue to protect Estonia to a certain extent against such volatility, given that FDI are considered the most stable form of external financing (Zanghieri, 2004).

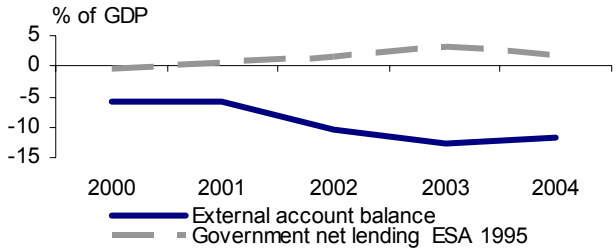
Fiscal policy and the external account

The fiscal policy design needs to take account of the other sectoral balance sheets

An external account deficit the size of Estonia's cannot and should not be corrected primarily by fiscal policy measures: a very large fiscal surplus fully offsetting the external imbalance would hardly be desirable nor politically sustainable in a country with huge – also public – investment needs and a low debt ratio. However, the country's fiscal policy design needs to take due account of the imbalances in the economy and the strength of other sectoral balance sheets. With private sector savings just starting to recover from the consumption, investment and construction boom that preceded EU accession, a firm commitment to continued fiscal discipline is crucial to maintaining an adequate level of national saving and to underpinning a sustainable correction of the external imbalance (European Commission, 2005).

In fact, the high credibility attached to the economic policy mix which is the backbone of Estonia's impressive economic success story has relied to a considerable extent on maintaining fiscal policy in surplus. The external balance has been strongly supported by budgetary policy: ever since the external account dipped into double digit deficits since 2002, the general government has produced solid surpluses, and thus helped counterbalance the decline in the private savings rate.

Chart 6: Fiscal policy in tandem with the external deficit



Source: European Commission services

Fiscal policy can contribute to preserving stability

The primary task for fiscal policy in a situation of a high external imbalance is to help preserve stability. In addressing private sector imbalances, fiscal policy can play various roles. First, it has a direct impact on domestic savings. The widening of the Estonian external account deficit does not originate from fiscal imbalances. On the contrary, public savings have increased considerably over the past few years, leading to a level of liquid government reserves of close to 10% of GDP at the end of 2004. Second, confidence-enhancing fiscal behaviour, including a credible track record of fiscal discipline and a low level of government debt, can effectively support external sustainability by maintaining positive investor sentiment. Third, pre-emptive fiscal tightening can be an effective response to deteriorating market conditions for external borrowing (which at present, however, is not a problem in Estonia). Fourth, there is the cyclical effect of fiscal tightening or expansion on economic activity. In the case of Estonia, the ongoing tax cuts are likely to have a stimulating effect, including on external trade. With growth rates still below estimated potential, there appear to be no immediate grounds for concern about possible pro-cyclical effects. Fifth, Estonia's prudent fiscal policy has contributed to avoiding an unwarranted degree of real appreciation through high inflation. And sixth, exceptional fiscal policy measures, such as pension reforms, can influence private households' consumption and saving behaviour, with repercussions on the external account (Watson, 2004). On a note of caution, longer-term fiscal projections made during periods of strong credit growth and asset price booms may be subject to considerable uncertainty, calling for particular prudence in developing fiscal strategies (Jaeger and Schuknecht, 2004).

Conclusions

Markets appear to perceive the risks as limited

Estonia's high external deficit can largely be attributed to 'normal' transitional effects in a rapidly catching up economy that is expanding its productive potential. In fact, the phenomenon appears to have already passed its peak. A considerable share of the external account deficit is financed by FDI, which in turn includes a large amount of reinvested earnings. A high level of government sector reserves, to the tune of over 10% of GDP, set aside over the past few years from budget surpluses, can also be considered to be stabilising – and confidence-enhancing – factors. While such reflections on the external sustainability put the external imbalance into perspective, the further trend of both public and private net saving as well as developments in competitiveness and FDI need to be closely monitored. Financial market sentiment can quickly turn from bull to bear, in which case the safety net that Estonia has prudently built up over recent years from its fiscal surpluses might have to be used. Provided the country continues its virtuous path of strong growth supported by a credible macroeconomic policy mix, the risks appear limited. There is no room for complacency, though. The business cycles of Scandinavian neighbour countries will continue to exert a strong and immediate impact on Estonia's trade balance, while services (especially foreign tourism) appear to be on a sustained growth trend. On the whole, it appears that – although temporarily overshooting – Estonia's external account deficit is perceived by financial markets rather as a sign of success than a problem, provided that policies remain geared towards containing risks and maintaining macroeconomic and financial stability.

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[1] The 'external account' is defined as: 'net lending/borrowing vis-à-vis the rest of the world = current account + capital account'. This concept has the advantage of fully taking account of EU transfers, which have become an important structural feature of the new Member States' balances of payment. Estonia's external account deficit is lower than the current account deficit, the difference being the capital account surplus.

[2] Bussière et al. (2004) derive a "structural" current account deficit for Estonia in the order of 6-9% of GDP.

[3] For a more in-depth discussion of the Irish catching up experience and new EU Member States, see European Commission (2004).

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