COMMISSION OF THE EUROPEAN COMMUNITIES

Bruxelles, le 24.6.2004
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Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Art. 9 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the convergence programme of Estonia, 2004-2008

(presented by the Commission)

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EXPLANATORY MEMORANDUM

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1] stipulates that non-participating Member States, that is, those which have not adopted the single currency, have to submit convergence programmes to the Council and the Commission for the purpose of multilateral surveillance at regular intervals under Article 99 of the Treaty.

In accordance with Article 9 of this Regulation, the Council has to examine each convergence programme based on assessments prepared by the Commission and the Committee set up by Article 114 of the Treaty (the Economic and Financial Committee). On the basis of a recommendation from the Commission and after consulting the Economic and Financial Committee, the Council is required to deliver an opinion, following its examination of the programme. According to the Regulation, Member States need to submit annual updates of their convergence programmes, which may also be examined by the Council in accordance with these same procedures.

The ten countries that joined the EU on 1 May 2004 have a derogation and thus do not yet participate in the single currency. They committed themselves to submitting their convergence programmes by 15 May 2004 and a first update thereof towards the end of 2004.

Estonia's convergence programme covering the period 2004-2008 was submitted on 13 May 2004. The Commission services have carried out a technical evaluation of this programme, taking into account the results of the Spring 2004 forecasts and having regard to the Code of Conduct[2] and the principles laid down in the Communication from the Commission to the Council and the European Parliament of 27 November 2002 on strengthening the co-ordination of budgetary policies[3]. This evaluation warrants the following assessment:

> The first Estonian convergence programme incorporates the measures taken in the budget for 2004, and is consistent with the State Budget Strategy 2004-2008. It was formally adopted by the Council of Ministers and thus represents the country's official medium-term macro-economic framework. The policy measures are consistent with the medium-term economic outlook as presented in the 2003 pre-accession economic programme (PEP). The programme spells out Estonia's intention to join ERM II and adopt the euro 'as soon as possible'. It claims that Estonia will be able to meet the criteria for euro zone membership throughout the programme period, but cautiously raises a caveat on future inflation developments (at present inflation is below that of the euro zone) .
>
> The programme largely complies with the "Code of Conduct on the content and format of stability and convergence programmes" Following a revision of the National Accounts which was published shortly after submission of the programme, GDP figures for the 1993-2003 period were revised upwards. Consequently, some of the figures and tables of the programme are by now outdated. Nonetheless, the

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1 OJ L209, 2.8.1997. All the documents referred to in this text can be found at the following website http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

2 Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes, endorsed by the ECOFIN Council on 10.7.2001.

3 COM (2002) 668 final, 27.11.2002.

overall picture and the assessment of the scenarios as they stand are not affected, given that the underlying trends of the projections do not change substantially.

A balanced government budget and the currency board arrangement are set to remain the anchors of macroeconomic stability in Estonia. The programme envisages steady real GDP growth between 5 and 6% p.a., driven by continued strong domestic demand and exports set to accelerate with the projected pick-up in external activity. Nonetheless, the net external contribution is expected to remain negative over the entire programme period. Both private consumption and investment are set to continue growing, albeit at a slowing pace. Unemployment would slowly abate to around 9.5% of the labour force. The envisaged recovery in the world economy and the resulting pick-up in export demand are expected to lead to a narrowing of the high current account deficit, which nonetheless is forecast to remain above 8% of GDP by 2008.

The macro-economic scenario appears broadly plausible. For the years 2004 and 2005, expected GDP growth is marginally below the Commission Spring forecast, while inflation is projected slightly higher. As compared with the 2003 PEP, the macro-economic scenario is somewhat lower with regard to GDP growth, accommodating the delay to the international economic recovery that has since set in, while the inflation and the unemployment outlook have improved on the basis of a better-than-expected turnout in 2003. The upcoming upward adjustment of growth figures in the Estonian forecast, following the National Accounts revision of 20 May 2004, adds to the plausibility of the scenarios as presented in the programme. A high external account deficit will continue to be the major macro-economic imbalance in Estonia over the foreseeable future, given the strong investment needs in the economy. The programme deals with this issue in detail. With the general government budget forecast to remain in small surplus or balance throughout the programme period, the stance of budgetary policy is basically set to underpin the improvement in the current account, but to a considerably more limited extent than was the case in 2002 and 2003. Strict budgetary discipline, including the setting aside of possible ‘surprise surpluses’ will thus continue to be a crucial element to a sustainable correction of the external imbalance.

The currency board system in place since the country’s independence – with the kroon pegged first to the DM and, since 1999, to the euro -, has served the country well and provides for high credibility among market participants. The monetary targeting through a hard peg to a strengthening euro helped to disinflate the Estonian economy quite rapidly, to an annual CPI increase of just 1.3% in 2003, but that rate is set to rise to around 3% over the medium term. Estonian interest rates are at a historical low, mirroring developments in the euro area and favourable international country ratings. Estonia aims at joining ERM II at an early stage, with a standard fluctuation band, while maintaining a unilateral commitment to the present currency board system. Also adoption of the euro is envisaged ‘as soon as possible’.

The budgetary strategy as outlined in the programme is for the general government accounts to remain in surplus of 0.7% of GDP in 2004, and arrive at balanced budgets from 2005 onwards. This is slightly more optimistic than the 2003 PEP scenario which indicated no more surpluses already from 2004, and in line with the Commission forecast until 2005. On the whole, this implies a considerable fiscal easing as compared with the surprisingly high 2003 surplus. The programme contains a firm commitment to adhere to the rules of the Stability and Growth Pact, and to maintain the government accounts in balance or surplus over the entire programme period. An ongoing reform of the tax system aims at a stepwise reduction of the flat tax rates for both the corporate and personal income tax, which will be combined with higher social transfers and increased tax allowances. Strong growth, savings on the expenditure side, increased VAT and excise duty revenues, along with changes to the spending structure and improved tax collection are expected to finance these reforms. Overall, while nominal spending is expected to increase, the expenditure ratio would decline. While the central government and the social security funds are projected to remain in surplus over the programme period (despite considerable transfer payments to a private second pension pillar of up to 1% of GDP), local governments are expected to remain in deficit, even if the latter should narrow. Public debt corresponded to 5.8% of GDP in 2003 and is projected to further decline from to just 3.2% of GDP by 2008. It is entirely covered by public sector reserves and represents a negligible risk to the Estonian economy.

The fiscal projections of the programme appear on the whole plausible, although the actual budgetary outcome may prove better than projected. This view is based in particular on a strong track record of prudent forecasting (and repeated overshooting of fiscal targets) in the past few years, a realistic growth forecast underpinning the programme's budget projections, possible further carry-over effects from the high 2003 surplus, slower-than-expected implementation of public investment spending based on EU transfers, but also the downward correction of deficit and debt ratios following the recent National Accounts revision. Downside risks, while not deemed acute from today's perspective, may nevertheless occur from a revenue shortfall due to the planned tax cuts, or adverse growth developments stemming from exogenous shocks. The swift melting of budgetary surpluses in 2004 and 2005 which would coincide with a projected acceleration of economic activity is likely to lead to a distinct pro-cyclical stance of the fiscal path envisaged in the programme. Furthermore, should an orderly and sequenced reduction of the external imbalance not materialise through a recovery of private domestic savings (as the programme suggests), a fiscal policy aiming at balanced budgets might not be sufficient to support the planned correction of the current account deficit.

The programme clearly spells out the country's intention to comply with the goals of the Lisbon strategy by 2010. Employment ratios should be increased both by reforms to vocational training and a reduction of social and income taxes on labour. The need for a broadening of the supply base of the economy (and of the tax base at the same time) will be addressed through infrastructure improvements as well as measures in education in order to decrease the present skills mismatch on the labour market. The low level of productivity will be addressed through stimulating R&D both in the private and public sphere, in order to further enhance the economy's growth development. With regard to public finances, the programme aims at implementing structural reforms both to the expenditure and revenue side. The reforms on the expenditure side aim in particular at a better targeting of social transfers towards the needy and a strengthening of incentives to work. On the revenue side, the comprehensive tax reform that has started in 2004 will gradually lead to a further shift from direct to indirect taxation, while maintaining a simple tax system. The reforms, most of which are already underway, can reasonably be expected to strengthen incentives to work, to create new jobs and to discouraging tax evasion.

Estonia is well placed to meet the projected budgetary costs of an ageing population. The considerable cost of implementing a fully funded private second pillar in the pension system is accounted for in the budgetary projections of the programme. A low government debt level, considerable government financial reserves and a medium-term budgetary strategy that is fully consistent with the objective of a close-to-balance or in surplus budgetary position together with the reforms of the pension and health care systems which are meant to stem budgetary pressures in the longer term should ensure that public finances remain on a sustainable footing.

Table: *Comparison of key macroeconomic and budgetary projections*

		2003	2004	2005	2006	2007	2008
Real GDP (% change)	**CP**	**4.7**	**5.3**	**5.8**	**5.6**	**5,9**	**5.8**
	COM	4.8	5.4	5.9	n.a.	n.a.	n.a.
	PEP	*4.5*	*5.6*	*6.0*	*6.0*	*6.0*	*n.a.*
HICP inflation (%)	**CP**	**1.3**	**3.1**	**3.0**	**2.8**	**2.8**	**2.8**
	COM	1.4	2.8	2.9	n.a.	n.a.	n.a.
	PEP	*1.7*	*3.8*	*3.4*	*3.2*	*2.8*	*n.a.*
General government balance (% of GDP)	**CP**	**2.6**	**0.7**	**0.0**	**0.0**	**0.0**	**0.0**
	COM	2.6	0.7	0.0	n.a.	n.a.	n.a.
	PEP	*0.4*	*0.0*	*0.0*	*0.0*	*0.0*	*n.a.*
Primary balance (% of GDP)	**CP**	**2.9**	**1.0**	**0.3**	**0.3**	**0.3**	**0.3**
	COM	2.9	1.0	0.3	n.a.	n.a.	n.a.
	PEP	*0.7*	*0.3*	*0.3*	*0.3*	*0.3*	*n.a.*
Government gross debt (% of GDP)	**CP**	**5.8**	**5.4**	**5.1**	**4.7**	**3.4**	**3.2**
	COM	5.8	5.4	5.3	n.a.	n.a.	n.a.
	PEP	*5.5*	*5.2*	*4.9*	*4.6*	*3.1.*	*n.a.*

Sources: Convergence programme (CP); August 2003 pre-accession economic programme (PEP); Commission services spring 2004 forecasts (COM)

Based on this assessment, the Commission has adopted the attached recommendation for a Council Opinion on the convergence programme of Estonia and is forwarding it to the Council.

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Art. 9 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the convergence programme of Estonia, 2004-2008

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[4], 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:

On [5 July 2004] the Council examined the convergence programme of Estonia, which covers the period 2004 to 2008. The programme largely complies with the data requirements of the revised "Code of Conduct on the content and format of stability and convergence programmes".

The budgetary strategy underlying the programme aims at maintaining sound public finances as defined by a budgetary position of close-to-balance or in surplus. To this end, after a surplus of 2.6% of GDP in 2003, the programme targets a small surplus of 0.7% in 2004 and balanced budgets from 2005 onwards, accompanied by a gradual reduction in both the revenue and expenditure ratio, following a rise in both ratios in 2004 in connection with EU accession. In particular, the programme incorporates reforms resulting in reduced direct taxes, combined with increased transfer payments and tax allowances. Strong growth, improved tax collection, savings on the expenditure side and changes to the spending structure along with increased VAT and excise duty revenues are projected to finance these reforms. The debt ratio, at 5.8% of GDP in 2003, is very low and set to decline further to 3.2% of GDP by 2008.

On the basis of currently available information, the macro-economic scenario underlying the programme seems to reflect plausible GDP growth assumptions of between 5 and 6% over the programme period. The main sources of growth would be domestic demand (around 7% p.a.),

4 OJ L209, 2.8.1997, p. 1. The documents referred to in this text can be found at the following website http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

and accelerating export growth of up to 10% annually. Private consumption is projected to grow at annual rates of 5 to 6%. Investment is set to stay lively, expanding at 7 to 9 % per year, albeit no longer at rates above 10% as was the case in recent years. The projection for inflation, which is set to increase to rates around 3% starting in 2004, after a record low of 1.3% in 2003, also appears realistic. The presently high current account deficit (13.7% of GDP in 2003) is projected to come down to levels around 8% of GDP by 2008.

The risks to the budgetary projections appear broadly balanced. On the one hand, Estonia has established a track record of prudent forecasting and repeated overshooting of fiscal targets over the past few years. On the other hand, unexpected revenue shortfall from the planned tax cuts, or adverse impacts on growth from exogenous shocks cannot be excluded altogether. Therefore the budgetary stance in the programme seems sufficient to achieve the Stability and Growth Pact's medium-term objective of budgetary position of close-to-balance; it should also provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations. However, the rapid reduction of surpluses as from 2004 over a period of continued buoyant growth, as envisaged in the programme, is likely to imply a distinct pro-cyclical fiscal stance.

At less than 6% of GDP, Estonia's debt-to-GDP ratio is almost the lowest in the EU and is expected to decline further by 2.6 percentage points over the programme period. The actual trend is likely to be even more favourable than projected given the recent National Accounts revision that will permanently increase GDP levels and thus the ratio's denominator.

Estonia is well placed to meet the budgetary costs of an ageing population. A low government debt level, considerable government financial reserves and a medium-term budgetary strategy that is fully consistent with the objective of a close-to-balance or in surplus budgetary position together with the reforms of the pension and health care systems which are meant to stem budgetary pressures in the longer term should ensure that public finances remain on a sustainable footing.

Key projections from the convergence programme of Estonia

	2003	2004	2005	2006	2007	2008
Real GDP growth (%)*	4.7	5.3	5.8	5.6	5.9	5.8
Employment growth (%)	1.5	0.9	0.7	0.3	0.2	0.2
HICP inflation (%)	1.3	3.1	3.0	2.8	2.8	2.8
General government balance (% of GDP)*	2.6	0.7	0.0	0.0	0.0	0.0
Government gross debt (% of GDP)*	5.8	5.4	5.1	4.7	3.4	3.2

* These ratios do not take into account the National Accounts revision of 20 May 2004, which led statistically to a permanently higher GDP level. 2003 figures will be revised as follows: real GDP growth 5.1%, general government balance 2.4% of GDP, government gross debt 5.3% of GDP.