COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 2.2.2005
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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 updated convergence programme of Estonia, 2004-2008

(presented by the Commission)

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. 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 Member States that joined the EU on 1 May 2004 do not participate in the single currency, but are required to fulfil in due time the convergence criteria, including the one on the sustainability of the government financial position, in order to qualify for the adoption of the euro.

The Member States which joined the EU on 1 May 2004 committed themselves to submitting their convergence programmes by 15 May 2004 and a first update thereof towards the end of 2004. The first convergence programme of Estonia, covering the period 2004-2008, was submitted on 1 May 2004 and assessed by the Council on 5 July 2004. Estonia submitted an update of its convergence programme on 1 December 2004. The Commission services have carried out a technical evaluation of this update, taking into account the results of the Commission services Autumn 2004 economic forecasts, and having regard to the "code of conduct on the content and format of stability and convergence programmes"[2], the commonly agreed methodology for the estimation of potential output, the recommendations in the broad economic policy guidelines for the period 2003-2005 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 coordination of budgetary policies[3]. This evaluation warrants the following assessment:

– The first update of the Estonian convergence programme was submitted to the European Commission on 1 December 2004. It covers the period 2004-2008. The programme complies with the "code of conduct on the content and format of stability and convergence programmes".

– The macroeconomic scenario as presented in the programme envisages real GDP growth of 5.6% in 2004. In 2005, real GDP is forecast to accelerate to 5.9% and to maintain a pace of 6% p.a. over the period 2006-2008. This is somewhat lower than the Commission services autumn 2004 forecast for the years 2004-2006, which projects growth rates of 5.9% in 2004, 6% in 2005 and 6.2% in 2006. Both projections remain below the Commission

1 OJ L 209, 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, document EFC/ECFIN/404/01-REV 1 of 27.6.2001 endorsed by the ECOFIN Council of 10.7.2001.

3 COM(2002) 668 final, 27.11.2002.

estimates of potential output growth for the years 2004-2007. On the basis of currently available information, and in particular given that the actual growth rate during the first 3 quarters of 2004 was 6.3% year-on-year, along with the Estonian authorities' track record of prudent government forecasting, the programme scenario can be considered as plausible. A high external account deficit will continue to be the major macro-economic imbalance in Estonia over the foreseeable future, largely reflecting the strong investment needs of the economy in catching up towards EU-average income levels. Although the programme projects a sustainable narrowing of the external deficit through structural improvements on the trade balance, present trends and less than reliable trade data plead in favour of caution.

- On 28 June 2004, Estonia joined ERM II with a standard fluctuation band, while maintaining a unilateral commitment to the present currency board system. The hard peg to the euro, supported by strong policy discipline, helped to disinflate the Estonian economy quite rapidly during the past years. Reflecting primarily EU accession effects, annual HICP inflation increased to 3% in 2004, but is expected to ease back over the medium term. Estonian money market and bank lending rates are at historical lows, reflecting developments in the euro area as well as sustained interest rate convergence.

- The programme update aims at achieving a budgetary position of close-to-balance or small surplus throughout the programme period. For 2004, a budget surplus of 1% of GDP is expected. From 2005 onwards, balanced budgets are targeted. Owing to buoyant growth of activity, government investment and consumption are expected to decline as ratios of GDP, while nominal expenditure on both items will increase. In parallel, revenues will decrease as per cent of GDP, primarily due to the net effects of an ongoing tax reform. While the overall strategy remained unaltered as compared with the May 2004 programme, the expected budget surplus for 2004 has been revised upwards to 1% of GDP, from 0.7%. The GDP growth projections have been raised over the entire programme period, although they still appear to be on the cautious side.

- The risks to the budgetary projections in the programme appear broadly balanced. On the one hand, the cautious macroeconomic scenario suggests that revenues could be higher and that expenditure somewhat lower than budgeted. Indeed, 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 shortfalls from the planned tax cuts, or an adverse impact on growth from exogenous shocks cannot be excluded altogether.

- In view of this risk assessment the budgetary stance in the programme seems adequate to maintain the Stability and Growth Pact's medium-term objective of a position of close-to-balance over the entire programme period. It also seems to provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations.

- The debt ratio is estimated at 4.8% of GDP in 2004, well below the 60% of GDP Treaty reference value and, indeed, the lowest in the EU. The programme projects the debt ratio to further decline by 1.9 percentage points up to the programme horizon.

- The programme briefly reviews the government's structural reform programme which focuses on measures to improve the country's infrastructure (using also EU funds for that purpose), the education and health care systems, and on active labour market policies as well as the promotion of innovation and research. The programme also outlines measures to further strengthen the budget process through a multi-annual budgeting framework, and to increase transparency and reliability of the nominal expenditure ceilings through systematic evaluation mechanisms. The local government deficits are planned to be brought under control through improved co-ordination of borrowing with the central government level, as well as mandatory preparation of a mid-term budget framework, the introduction of limits for annual deficits, and the mandatory accumulation of reserves. The reforms, most of which are already underway or whose legislation is being prepared, can reasonably be expected to improve growth conditions of the Estonian economy, while strengthening incentives to work, creating new jobs and discouraging tax evasion, as well as improving fiscal discipline both with line ministries and at local government level. Encouraging early results, especially in the labour market, have become visible already in 2004.

– Estonia appears to be in a favourable position with regard to the long-term sustainability of the public finances, of which the projected budgetary cost of an ageing population is an important element. 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 credible and thorough 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.

– The economic policies outlined in the update are broadly consistent with the country-specific broad economic policy guidelines in the area of public finances. The higher-than-projected budget surplus in 2004 is in line with the recommendation to avoid pro-cyclical fiscal policies. Nevertheless, given that the external account deficit has most likely not narrowed significantly (if at all) in 2004, a rapid run-down of the budget surplus may provide insufficient support from the fiscal policy stance to the correction of the external imbalance.

Based on this assessment, the Commission has adopted the attached recommendation for a Council Opinion on the updated 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 updated 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:

(1) On [17 February 2005] the Council examined the updated convergence programme of Estonia, which covers the period 2004 to 2008. The programme complies with the data requirements of the revised "code of conduct on the content and format of stability and convergence programmes".

(2) The macro-economic scenario underlying the programme envisages real GDP growth to pick up from 5.6% in 2004 to 6.0% on average over the rest of the programme period. On the basis of currently available information, this scenario seems to reflect plausible growth assumptions. The programme's projections for inflation also appear realistic.

(3) Estonia aims at achieving a budgetary position of close-to-balance or small surplus throughout the programme period. For 2004, the programme targets a budget surplus of 1% of GDP which is 0.3% higher than the surplus planned in the programme of last May. From 2005 onwards, balanced budgets are envisaged, as was the case in the previous programme. Public investment in 2004 is foreseen to increase by one percentage point of GDP to 4.4% before declining to 3.9% by 2008, and remains thus well above the EU average (2.4% of GDP in 2004).

4 OJ L 209, 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.

(4) The risks to the budgetary projections in the programme appear broadly balanced. On the one hand, the cautious macroeconomic scenario suggests that revenues could be higher and expenditure somewhat lower than budgeted. Indeed, 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 shortfalls from the planned tax cuts, or an adverse impact on growth from exogenous shocks cannot be excluded altogether. Considering the balance of risks, the budgetary stance in the programme seems adequate to maintain the Stability and Growth Pact's medium-term objective of a position of close-to-balance over the entire programme period 2004-2008. It also seems to provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations.

(5) The debt ratio is estimated at 4.8% of GDP in 2004, well below the 60% of GDP Treaty reference value and indeed the lowest in the EU. The programme projects the debt ratio to further decline by 1.9 percentage points over the programme period.

(6) Estonia appears to be in a favourable position with regard to the long-term sustainability of the public finances, despite important projected 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 credible and thorough 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.

(7) The economic policies outlined in the update are broadly consistent with the country-specific broad economic policy guidelines in the area of public finances. The higher-than-projected budget surplus in 2004 is in line with the recommendation to avoid pro-cyclical fiscal policies. Nevertheless, given that the external account deficit has most likely not narrowed significantly (if at all) in 2004, a rapid run-down of the budget surplus may provide insufficient support from the fiscal policy stance to the correction of the external imbalance.

Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007	2008
Real GDP (% change)	**CP Dec 2004**	**5.6**	**5.9**	**6.0**	**6.0**	**6.0**
	COM Oct 2004	5.9	6.0	6.2	n.a.	n.a.
	CP May 2004	*5.3*	*5.8*	*5.6*	*5.9*	*5.8*
HICP inflation* (%)	**CP Dec 2004**	**3.3**	**3.2**	**2.5**	**2.8**	**2.8**
	COM Oct 2004	3.4	3.5	2.8	n.a.	n.a.
	CP May 2004	*3.1*	*3.0*	*2.8*	*2.8*	*2.8*
General government balance (% of GDP)	**CP Dec 2004**	**1.0**	**0.0**	**0.0**	**0.0**	**0.0**
	COM Oct 2004	0.5	0.2	0.1	n.a.	n.a.
	CP May 2004	*0.7*	*0.0*	*0.0*	*0.0*	*0.0*
Primary balance (% of GDP)	**CP Dec 2004**	**1.3**	**0.2**	**0.2**	**0.2**	**0.2**
	COM Oct 2004	0.8	0.4	0.3	n.a.	n.a.
	CP May 2004	*1.0*	*0.3*	*0.3*	*0.3*	*0.3*
Government gross debt (% of GDP)	**CP Dec 2004**	**4.8**	**4.6**	**4.3**	**3.1**	**2.9**
	COM Oct 2004	4.8	4.4	4.2	n.a.	n.a.
	CP May 2004	*5.4*	*5.1*	*4.7*	*3.4*	*3.2*

Note:
*the programme refers to the national CPI definition, not the HICP
Sources: convergence programme (CP); Commission services autumn 2004 forecasts (COM).