



COMMISSION OF THE EUROPEAN COMMUNITIES

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Recommendation for a

COUNCIL OPINION

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

On the updated convergence programme of Estonia, 2006-2010

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. GENERAL BACKGROUND

The Stability and Growth Pact, which entered into force on 1 July 1998, is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. The 2005 reform of the Pact acknowledged its usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies¹, which is part of the Stability and Growth Pact, stipulates that Member States have to submit, to the Council and the Commission, stability or convergence programmes and annual updates thereof (Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes). The first convergence programme of Estonia was submitted in May 2004. In accordance with the Regulation, the Council delivered an opinion on it on 5 July 2004 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. In accordance with the same procedure, updated stability and convergence programmes are assessed by the Commission and examined by the Committee mentioned above, while the Council may examine them.

2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission has examined the most recent update of the convergence programme of Estonia, submitted on 1 December 2006, and has adopted a recommendation for a Council opinion on it (see box for the main points covered by the assessment).

In order to set the scene against which the budgetary strategy in the updated convergence programme is assessed, the following paragraphs summarise:

- (1) the economic and budgetary performance over the last ten years
- (2) the most recent assessment of the country's position under the preventive arm of the Stability and Growth Pact (summary of the Council opinion on the previous update of the convergence programme) and
- (3) the Commission's assessment of the October 2006 national reform programme.

2.1. Recent economic and budgetary performance

Estonia successfully completed the transition to a functioning market economy and now enjoys the highest economic growth rate in the EU. Labour and product markets are highly flexible. The combination of high wage increases in tune with large productivity gains has

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). 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

enabled the country to rapidly catch up with the EU in terms of living standards. Along with a strong export performance, domestic demand has accelerated rapidly in the past years. More recently, Estonia's very success has been creating new challenges. After several years of rapid growth, the economy is facing capacity constraints, in particular in the labour market, which is drying out. The significant risk of overheating is indicated by rising core inflation, a large external deficit and strong credit growth feeding into a real estate boom.

2.2. The assessment in the Council opinion on the previous programme

On 14 February 2006, the Council adopted its opinion on the previous update of the convergence programme, covering the period 2005-2009. The Council was of the opinion that “overall the budgetary position is sound, and the budgetary strategy provides a good example of fiscal policy conducted in compliance with the Pact”. In view of “a budgetary outturn in 2005 significantly better than estimated in the programme and the need to avoid pro-cyclical policies”, the Council invited Estonia to “aim for a higher budgetary surplus in 2006 and in the subsequent years in order to continue supporting the correction of the external imbalance”.

2.3. The Commission assessment of the October 2006 national reform programme

The implementation report of the national reform programme of Estonia, provided in the context of the renewed Lisbon strategy for growth and jobs, was submitted on 12 October 2006. Estonia's national reform programme identifies as key challenges/priorities: R&D and innovation, and employment

The Commission's assessment of this programme (adopted as part of its December 2006 Annual Progress Report²) showed that Estonia is making very good progress with the implementation of its National Reform Programme. It also makes impressive efforts to ensure coherence between the National Reform Programme and cohesion policy.

Against the background of progress made, Estonia was encouraged to also focus on the areas of: education and lifelong learning; R&D and innovation; competition policy; labour market flexibility and active labour market policies.

² Communication from the Commission to the Spring European Council, “Implementing the renewed Lisbon strategy for growth and jobs - A year of delivery” - COM(2006) 816, 12.12.2006.

Box: Main points covered by the assessment

As required by Article 5(1) (for stability programmes) and Article 9(1) (for convergence programmes) of Council Regulation (EC) No 1466/97, the assessment covers the following points:

- whether the economic assumptions on which the programme is based are plausible;
- the medium-term budgetary objective (MTO) presented by the Member State and whether the adjustment path towards it is appropriate;
- whether measures being taken and/or proposed to respect that adjustment path are sufficient to achieve the MTO over the cycle;
- when assessing the adjustment path towards the MTO, whether a higher adjustment effort is made in economic good times, whereas the effort may be more limited in economic bad times, and, for euro-area and ERM II Member States, whether the Member State pursues an annual improvement of the cyclically-adjusted balance, net of one-off and other temporary measures, of 0.5% of GDP as a benchmark to meet its MTO;
- when defining the adjustment path to the MTO (for Member States that have not yet reached it) or allowing a temporary deviation from the MTO (for Member States that have), the implementation of major structural reforms which have direct long-term cost-saving effects (including by raising potential growth) and therefore a verifiable impact on the long-term sustainability of public finances (subject to the condition that an appropriate safety margin with respect to the 3% of GDP reference value is preserved and that the budgetary position is expected to return to the MTO within the programme period), with special attention for pension reforms introducing a multi-pillar system that includes a mandatory, fully-funded pillar;
- whether the economic policies of the Member State are consistent with the broad economic policy guidelines.

The plausibility of the programme's macroeconomic assumptions is assessed by reference to the Commission services' autumn 2006 forecast, using also the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances. The assessment of consistency with the broad economic policy guidelines is made against the broad economic policy guidelines in the area of public finances as included in the integrated guidelines for the period 2005-2008.

The assessment also examines:

- the evolution of the debt ratio and the outlook for the long-term sustainability of the public finances, which should be given "sufficient attention in the surveillance of budgetary positions" according to the Council report of 20 March 2005 on "Improving the implementation of the Stability and Growth Pact". A Commission Communication of 12 October 2006 sets out the approach to the assessment of long-term sustainability³;
- the degree of integration with the national reform programme, submitted by Member States in the context of the Lisbon strategy for growth and jobs. In its cover note of 7 June 2005 to the European Council on the broad economic policy guidelines for the period 2005-2008, the ECOFIN Council stated that the national reform programmes should be consistent with the stability and convergence programmes;
- compliance with the code of conduct⁴, which inter alia prescribes a common structure and set of data tables for the stability and convergence programmes.

³ Communication from the Commission to the Council and the European Parliament, "The long-term sustainability of public finances in the EU" - COM(2006) 574, 12.10.2006 - and European Commission, Directorate-General for Economic and Financial Affairs (2006), "The long-term sustainability of public finances in the European Union", European Economy No 4/2006.

⁴ "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005.

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On the updated convergence programme of Estonia, 2006-2010

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 policies⁵, 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 [27 February 2007] the Council examined the updated convergence programme of Estonia, which covers the period 2006 to 2010.
- (2) The macroeconomic scenario underlying the programme envisages that real GDP growth abates from a peak of 11% in 2006 to 8¼% in 2008 and 7½% per year in the outer years. Assessed against currently available information, this scenario appears to be based on cautious growth assumptions. However, the projected medium-term path of a smooth deceleration of growth from the current pace prone to overheating is clearly surrounded by risks. The programme's projections for inflation appear realistic.
- (3) For 2006, the general government surplus is estimated at 2.5% of GDP in the Commission services' autumn 2006 forecast, against a target of 0.3% of GDP set in the previous update of the convergence programme. The much better outcome, also expected in the new update, arises from carry-over from the better-than-expected outcome in 2005 and from the growth surprise in 2006.
- (4) The main goals of the medium-term budgetary strategy embodied in the programme are keeping the general government finances at least in balance and securing long-term

⁵ 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://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

sustainability in the light of the budgetary impact of population ageing. The budgetary strategy foresees the headline general government surplus to decline from 2½% of GDP in 2006 to around 1¼% in 2007-2008 and rebound to around 1½% of GDP thereafter. The primary balance will follow a similar profile, given the negligible weight of interest expenditure. The drop in the surplus in 2007 is driven by a rise in the expenditure-to-GDP-ratio while the revenue ratio follows a declining trend. From 2008 onwards, the overall revenue and expenditure ratios decline in lock-step, reflecting notably the income tax cuts and expenditure growth remaining below the buoyant nominal GDP growth. The new programme departs from the past practice of always targeting zero balance for general government finances (which were as a rule overachieved over the last years) and targets instead a sizeable surplus over the entire programme period, which is a step forward in responding to the cyclical conditions of the economy. Compared to the previous update, the targets from 2007 onwards have been revised upwards by at least 1 percentage point of GDP against the background of a more favourable (and more realistic) macroeconomic scenario.

- (5) The structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) calculated according to the commonly agreed methodology is planned to drop by about 1 percentage point to reach ½% of GDP in 2007, and rebound to above 1% of GDP in 2008 and above 1½% of GDP in 2009 and 2010. As in the previous update of the convergence programme, the medium-term objective (MTO) for the budgetary position presented in the programme is a balanced position in structural terms which the programme plans to maintain throughout the programme period. As the MTO is more demanding than the minimum benchmark (estimated at a deficit of around 2% of GDP), achieving it should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The MTO lies within the range indicated for euro-area and ERM II Member States in the Stability and Growth Pact and the code of conduct and is significantly more demanding than implied by the debt ratio and average potential output growth in the long term.
- (6) The risks to the budgetary projections in the programme appear broadly balanced. The programme's macroeconomic assumptions can be regarded as cautious over the programme period. The tax revenue projections appear overall plausible. However, the achievement of the envisaged moderation in expenditure growth would benefit from making the medium-term fiscal planning framework more binding.
- (7) In view of this risk assessment, the budgetary stance in the programme seems sufficient to maintain the MTO by a large margin throughout the programme period, as envisaged in the programme. A fortiori, it provides a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations over the programme period. The fiscal policy stance implied by the programme is not fully in line with the Stability and Growth Pact in the sense that it is pro-cyclical in good times during 2007, when the structural balance is set to decline by around 1% of GDP.
- (8) Government gross debt is estimated to have fallen to 3.7% of GDP in 2006, far below the 60% of GDP Treaty reference value. The programme projects the debt ratio to decline by a further 2 percentage points over the programme period.
- (9) The long-term budgetary impact of ageing in Estonia is among the lowest in the EU, with age-related expenditure projected to fall as a share of GDP over the coming

decades, influenced by the considerable expenditure-reducing impact of the reform of the pension system. 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 containing the risks to the long-term sustainability of public finances. Overall, Estonia appears to be at low risk with regard to the sustainability of public finances.

- (10) The convergence programme contains a qualitative assessment of the overall impact of the October 2006 Implementation Report of the National Reform Programme within the medium-term fiscal strategy. In addition, it provides some information on the direct budgetary costs or savings of the main reforms envisaged in the National Reform Programme and its budgetary projections explicitly take into account the public finance implications of the actions outlined in the National Reform Programme. The measures in the area of public finances envisaged in the convergence programme seem consistent with those foreseen in the National Reform Programme. In particular, both programmes emphasise prudent fiscal policies as a crucial element of macroeconomic stabilisation.
- (11) The budgetary strategy in the programme is broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008.
- (12) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme provides all required and most of the optional data⁶.

The overall conclusion is that the medium-term budgetary position is sound and the budgetary strategy provides a good example of fiscal policies conducted in compliance with the Stability and Growth Pact. Nevertheless, the planned weakening of the budgetary surplus in 2007 during good economic times implies a pro-cyclical stance of fiscal policy.

In view of the above assessment, Estonia is invited to aim for a higher budgetary surplus in 2007 than planned in the programme so as to foster macroeconomic stability and to continue supporting the correction of the external imbalance.

⁶ In particular, some labour market variables and the data on net lending/borrowing of the private sector are missing.

Comparison of key macroeconomic and budgetary projections

		2005	2006	2007	2008	2009	2010
Real GDP (% change)	CP Dec 2006	10.5	11.0	8.3	7.7	7.6	7.5
	COM Nov 2006	10.5	10.9	9.5	8.4	n.a.	n.a.
	CP Nov 2005	6.5	6.6	6.3	6.3	6.3	n.a.
HICP inflation (%)	CP Dec 2006	4.1	4.4	4.3	4.4	3.5	3.2
	COM Nov 2006	4.1	4.4	4.2	4.6	n.a.	n.a.
	CP Nov 2005	3.5	2.6	2.6	2.7	2.7	n.a.
Output gap (% of potential GDP)	CP Dec 2006¹	0.2	2.0	1.2	0.2	-0.3	-0.7
	COM Nov 2006 ⁵	0.0	1.2	0.9	-0.6	n.a.	n.a.
	CP Nov 2005 ¹	-0.4	-0.6	-0.7	-0.5	-0.1	n.a.
General government balance (% of GDP)	CP Dec 2006	2.3	2.6	1.2	1.3	1.6	1.5
	COM Nov 2006	2.3	2.5	1.6	1.3	n.a.	n.a.
	CP Nov 2005	0.3	0.1	0.0	0.0	0.0	n.a.
Primary balance (% of GDP)	CP Dec 2006	2.5	2.8	1.4	1.4	1.7	1.6
	COM Nov 2006	2.5	2.7	1.8	1.5	n.a.	n.a.
	CP Nov 2005	0.5	0.3	0.2	0.1	0.1	n.a.
Cyclically-adjusted balance (% of GDP)	CP Dec 2006¹	2.2	2.0	0.8	1.2	1.7	1.7
	COM Nov 2006	2.3	2.2	1.4	1.5	n.a.	n.a.
	CP Nov 2005 ¹	0.4	0.3	0.2	0.1	0.0	n.a.
Structural balance ² (% of GDP)	CP Dec 2006³	2.2	1.4	0.4	1.2	1.7	1.7
	COM Nov 2006 ⁴	2.2	1.5	1.0	1.3	n.a.	n.a.
	CP Nov 2005	0.4	0.3	0.2	0.1	0.0	n.a.
Government gross debt (% of GDP)	CP Dec 2006	4.5	3.7	2.6	2.3	2.1	1.9
	COM Nov 2006	4.5	4.0	2.7	2.1	n.a.	n.a.
	CP Nov 2005	4.6	4.4	3.3	3.0	2.8	n.a.

Notes:

¹ Commission services calculations on the basis of the information in the programme.

² Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures.

³ One-off and other temporary measures taken from the programme (0.6% of GDP in 2006 and 0.4% in 2007; all deficit-reducing).

⁴ One-off and other temporary measures taken from the Commission services' autumn 2006 forecast (0.2% of GDP in 2005, 0.6% of GDP in 2006, 0.4% of GDP in 2007 and 0.2% in 2008; all deficit-reducing).

⁵ Based on estimated potential growth of 9.1%, 9.6%, 9.9% and 9.9% respectively in the period 2005-2008.

Source:

Convergence programme (CP); Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations.