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, 2007-2011

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. GENERAL BACKGROUND

The Stability and Growth Pact 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 policies[1], which is part of the Stability and Growth Pact, stipulates that each Member State has to submit, to the Council and the Commission, a stability or convergence programme 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. As regards updated stability and convergence programmes, the regulation foresees that these are assessed by the Commission and examined by the Committee and if necessary and following the same procedure as set out above, the updated programmes may be examined by the Council.

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 29 November 2007, and is recommending 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 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);

(2) the country’s commitments undertaken at the time of entry into ERM II, the exchange rate mechanism;

(3) the March 2007 update of the country-specific broad economic policy guidelines in the area of budgetary policies;

(4) the Commission’s assessment of the October 2007 implementation report of the national reform programme.

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[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 are available at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

2.1. The assessment in the Council opinion on the previous update

In its opinion of 27 February 2007, the Council summarised its assessment of the previous update of the convergence programme, covering the period 2006-2010, as follows. “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”.

2.2. ERM II commitments of Estonia

On 28 June 2004, the Estonian kroon joined ERM II[2] and Estonia undertook the following commitments to ensure a smooth participation in ERM II[3]:

“The agreement on participation of the kroon in ERM II is based on a firm commitment by the Estonian authorities to continue with sound fiscal policies, which are essential for preserving macroeconomic stability, for supporting an orderly and substantial reduction of the current account deficit, and for ensuring the sustainability of the convergence process. The authorities will closely monitor macroeconomic developments together with the responsible EU bodies, and they will strengthen the fiscal stance if warranted. To help reduce the external imbalance and contain it at a sustainable level, they will take the necessary measures to contain domestic credit growth and ensure effective financial supervision, and they will promote wage moderation. Structural reforms aimed at further enhancing the economy’s flexibility and adaptability will be implemented in a timely fashion so as to strengthen domestic adjustment mechanisms and maintain the overall competitiveness of the economy”.

The updated convergence programme contains a self-assessment of the implementation of these commitments.

2.3. March 2007 update of the country-specific broad economic policy guidelines in the area of budgetary policies

On 27 March 2007, the Council adopted a recommendation on the 2007 update of the broad guidelines for the economic policies of the Member States and the Community and on the implementation of Member States' employment policies[4]. Estonia was not recommended to take particular action in the area of budgetary policies.

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[2] ERM II is the exchange rate mechanism established by the Resolution of the European Council on the establishment of an exchange-rate mechanism in the third stage of economic and monetary union of 16 June 1997 (OJ C 236, 2.8.1997, p. 5).

[3] Available at: http://ec.europa.eu/economy_finance/publications/eurorelated_en.htm.

[4] OJ L 92, 3.4.2007, p. 23.

2.4. The Commission assessment of the October 2007 implementation report of the national reform programme

On 11 December 2007, the Commission adopted its Strategic Report on the renewed Lisbon strategy for growth and jobs, which included an assessment of the October 2007 implementation report of Estonia's National Reform Programme[5] and was summarised as follows:

Estonia's National Reform Programme identified as key challenges: R&D and innovation, as well as employment challenges.

The Commission's assessment was that Estonia has been making very good progress in implementing its National Reform Programme over the 2005-2007 period.

Against the background of progress made, the Commission recommended that Estonia was encouraged to focus on the areas of: macroeconomic stability and fight against inflation; R&D and innovation; cooperation between universities and enterprises; immunity and leniency programme as well as competition enforcement; active labour market policies and lifelong learning; labour law modernization and flexible forms of work.

[5] Communication from the Commission to the European Council, "Strategic report on the renewed Lisbon strategy for growth and jobs: launching the new cycle (2008-2010)" - COM(2007) 803, 11.12.2007.

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 2007 forecast, using also the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances.

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 sustainability[6];
- the degree of consistency with the national reform programme, submitted by Member States in the context of the Lisbon strategy for growth and jobs, and its October 2007 implementation report. 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 conduct[7], which inter alia prescribes a common structure and set of data tables for the stability and convergence programmes.

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6 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.

7 "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, 2007-2011

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[8], 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 contributed to the emergence of a wage-price spiral and wage growth having outpaced that of productivity, leading to deteriorating 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 downwards risks, though these are mitigated by the high degree of flexibility that the economy has hitherto demonstrated.

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8 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.

(3) The macroeconomic scenario underlying the programme envisages that real GDP growth will moderate from 7½% in 2007 to 5¼% in 2008 and 6½% on average over the rest of the programme period. Assessed against currently available information[9], this scenario appears to be based on cautious growth assumptions for 2008 and plausible growth assumptions thereafter. The programme projects inflation to rise to 8½% in 2008 and remain high at 5½% 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 deteriorating competitiveness hampers this improvement.

(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[10]. 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 ½ 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 1¼% of GDP in 2007 to ¾% in 2008 and increase again to 1½-1¼% of GDP beyond 2008. Compared to the previous update of the convergence programme, fiscal targets have been confirmed for 2008 and lowered by around ½ 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

9 The assessment takes notably into account the Commission services' autumn forecast and the Commission assessment of the October 2007 implementation report of the national reform programme.

10 OJ C 72, 29.3.2007, p. 5.

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 more unfavourable 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.

(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, 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 both in private and public sector in the context of rapid economic growth and a tight labour market and represents currently 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[11].

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 over-achieving 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 Estonia 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 broadly 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 appropriate public wage policy and further labour market reforms so as to contain inflationary pressures and sustain rapid productivity growth.

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[11] 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.

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.*
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.

Source:

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