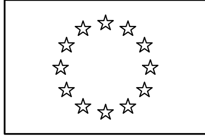

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 18.2.2009
SEC(2009) 193 final

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, 2008-2012

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. In particular, it introduced greater flexibility in the application of the rules governing the excessive deficit procedure, notably with regard to definition of "exceptional circumstances" and the setting of deadlines for the correction of an excessive deficit.

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.

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 5 December 2008, and has adopted a recommendation for a Council opinion on it.

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

(1) the Commission Communication of 26 November 2008 (“A European Economic Recovery Plan”);

(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).

2.1. The Commission Communication of 26 November 2008 (“A European Economic Recovery Plan”)

In view of the unprecedented scale of the global financial and economic crisis, the European Commission has called for a European Economic Recovery Plan (EERP)[2]. The plan proposes a co-ordinated counter-cyclical macro-economic response to the crisis in the form of an ambitious set of actions to support the economy consisting of (i) an immediate budgetary impulse amounting to €200 bn. (1.5% of EU GDP), made up of a budgetary expansion by

[1] OJ L 209, 2.8.1997, 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] Communication from the Commission to the European Council of 26 November 2008 - COM(2008) 800.

Member States of € 170 bn. (around 1.2% of EU GDP) and EU funding in support of immediate actions of the order of €30 bn. (around 0.3 % of EU GDP); and (ii) a number of priority actions grounded in the Lisbon Strategy and designed to adapt our economies to long-term challenges, continuing to implement structural reforms aimed at raising potential growth. The plan calls for the fiscal stimulus to be differentiated across Member States in accordance with their positions in terms of sustainability of government finances and competitive positions. In particular, for Member States outside the euro area with significant external and internal imbalances, budgetary policy should essentially aim at correcting such imbalances. The plan was agreed by the European Council on 11 December 2008. In this context, Member States were asked to submit an addendum to their updated stability or convergence programme, so as to reflect the measures taken in the context of the Recovery Plan. The examination of how measures (budgetary measures as well as structural measures) contribute to the recovery process in the short term is made in the opinions of stability convergence programmes.

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

In its opinion of 4 March 2008, the Council summarised its assessment of the previous update of the convergence programme, covering the period 2007-2011, as follows. “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 the light of this assessment and with a view to contributing to reducing risks to macroeconomic stability, the Council invited Estonia to “aim for a neutral fiscal stance in 2008 and beyond and complement the recommended fiscal stance with ensuring appropriate public wage policy and further labour market reforms as well as sustaining rapid productivity growth so as to contain inflationary pressures”.

Recommendation for a

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On the updated convergence programme of Estonia, 2008-2012

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[3], 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 [10 March 2009] the Council examined the updated convergence programme of Estonia, which covers the period 2008 to 2012.

(2) The Estonian economy is currently experiencing a severe downturn. During 2008 several external factors, notably the deepening global financial crisis and weakening external demand, added to the ongoing fall in domestic demand and contributed to speeding up the contraction of the economy. While subdued domestic demand and lower world commodity prices support a moderation of external and internal imbalances, weak cost competitiveness accumulated during the previous years of high growth inhibit an orderly economic adjustment. Wage growth far in excess of productivity growth, including in the public sector, and the lagged adjustment of the labour market to the downturn have contributed to the loss of competitiveness. In the context of the currency board framework, monetary and credit conditions tightened in 2008 amid higher country risk perceptions and a continued appreciation of the real effective exchange rate. Public finances have deteriorated markedly after six years of nominal surpluses, with an expected deficit of around 2% of GDP in 2008 and a further deterioration in 2009 and 2010. Given the adjustment needs stemming from the country's imbalances, the authorities envisage fiscal consolidation in order to facilitate the adjustment process and help maintain market confidence.

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[3] OJ L 209, 2.8.1997, 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 estimates real GDP to have declined by 2.2% in 2008 and projects a further contraction by 3.5% in 2009. Thereafter GDP is projected to recover to 2.6% growth in 2010 and average annual growth of 4.9% in 2011 and 2012. Assessed against currently available information[4], this scenario is based on favourable growth assumptions for 2009 and 2010, reflecting an optimistic assessment of export market growth and not fully taking into account more recent information pointing to a further deterioration in economic and confidence indicators. The programme's projections for inflation appear realistic. The external balance is set to improve in the programme's scenario at a somewhat lower rate than in the Commission services' January 2009 interim forecast, due to more favourable expectations regarding domestic demand and different external price assumptions.

(4) For 2008, the general government deficit is estimated at 2.0% of GDP in the Commission services’ January 2009 interim forecast, against a target of a surplus of 1.3% of GDP set in the previous update of the convergence programme. The deterioration reflects most notably a marked fall in revenue compared with the initial estimates due to a considerable worsening of the macroeconomic situation compared with projections in the previous update of the convergence programme. The deterioration in revenue was to some extent offset by lower expenditure compared with the previous target following the adoption in mid-2008 of a restrictive supplementary budget with broad-based expenditure cuts.

(5) The target for the general government balance in 2009 is a deficit of 1.7% of GDP, which compares with a deficit projection of 3.2% of GDP in the Commission services' interim forecast. Fiscal policy in the short term is geared towards restoring market confidence and limiting the divergence from the Treaty reference value, given the authorities' euro adoption objective. Expenditure growth in the 2009 budget is nevertheless expected to exceed nominal GDP growth, in particular due to an increase in pensions as a result of the indexation formula in force. The budgetary strategy for 2009 comprises some revenue-increasing measures and postponement until 2010 of previously planned tax cuts. Overall, the 2009 fiscal stance as measured by the change in the structural (cyclically-adjusted net of one-off and other temporary measures) balance is expected to be restrictive.

(6) The medium-term budgetary strategy of the programme is to achieve a structural surplus, thus overachieving the medium-term objective (MTO), defined as a balanced budget in structural terms. The general government headline deficit is expected to narrow to 1.0% of GDP in 2010 and to turn to surpluses of 0.1% of GDP in 2011 and 0.2% of GDP in 2012. The adjustment is foreseen to be expenditure-based with expenditure growth (underpinned by unspecified measures) below that of nominal GDP in all years starting from 2010. Revenue growth is set to recover partially following the turnaround of the economy, taking into account tax cuts foreseen by existing legislation for 2010-2012.

(7) The budgetary outcomes are subject to downside risks, in particular for 2009 and 2010, as the macroeconomic scenario is based on favourable growth assumptions. The projected return of the general government deficit to a surplus from 2011 onwards

[4] The assessment notably takes into account Commission services' January 2009 interim forecast, but also other information that has become available since then.

may also prove challenging, taking into account the programme's lack of information as regards the measures underpinning the expenditure-based fiscal consolidation.

(8) 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, which are currently at low level.

(9) The budgetary framework is based on a rule of ex-ante nominal balance or surplus of the general government. Although the rule does not have any legal underpinning, it has normally been respected in the years prior to the current downturn. In recent years, the government has adapted the implementation of the rule by better taking into account cyclical conditions of the economy, as some budgets at the peak of the cycle have been adopted with ex ante surpluses. However, the expenditure planning framework remains weak, as initial expenditure targets have systematically been raised in supplementary budgets, facilitated by higher than expected revenue in previous good economic times. Strengthening the medium-term expenditure framework and increasing expenditure efficiency therefore becomes particularly important in the current economic downturn and would help in mitigating the impact of less buoyant revenue on public finances. According to the convergence programme, the government intends to move towards performance- and accrual-based budgeting, initially in the form of pilot projects, with a view to strengthening the medium-term budgeting process.

(10) With a view to stabilising the financial sector, the Estonian authorities have increased the deposit guarantee coverage from the kroon equivalent of €20 000 to €50 000 and extended the deposit guarantee ratio to 100%, both with effect from 9 October 2008. In addition, a package of legislative proposals to make crisis management more flexible, including by establishing fast-track procedure for state intervention, was submitted to Parliament in December 2008.

(11) In line with the European Economic Recovery Plan (EERP) agreed in December 2008 by the European Council, Estonia, as a country facing significant external and internal imbalances has aimed its budgetary policy at correcting such imbalances. Taking also into account risks to the budgetary outcome and difficulty in securing new financing at acceptable conditions due to market risk aversion, the overall restrictive fiscal stance planned in 2009 and 2010 is thus an adequate response. In the context of the National Reform Programme, the Estonian authorities have enacted a number of structural reforms with neutral or limited short term budgetary impact, in particular measures to support labour market and investment, while there has been less emphasis on measures that support industrial sectors and household purchasing power. Two measures to support the labour market are adoption of the modernised Labour Law and an ongoing reform of the Public Service Law to raise the flexibility in the market, while increasing unemployment benefit rates and broadening the range of beneficiaries to enhance security. These measures are related to the medium-term reform agenda and the country-specific recommendation proposed by the Commission on 28 January 2009 under the Lisbon Strategy for Growth and Jobs.

(12) The fiscal stance is expected to be restrictive in 2009-2011 and to turn mildly expansionary in 2012. Although the safety margin against normal cyclical fluctuations is respected in all years starting from 2009, this may become insufficient, due to the severe downturn, to prevent breaching the 3% threshold in 2009 and 2010. Taking into account risks, the planned return to surplus may also not be achieved in 2011, as projected in the programme. Moreover, the adjustment should be backed by measures. In the context of Estonia's ERM II membership and the need to improve the economy's cost competitiveness, correction of previously high wage growth would be warranted.

(13) 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[5].

The overall conclusion is that Estonia is currently facing a severe economic downturn following years of above-potential economic growth. This is being aggravated by the global financial crisis and subdued external demand. Weakened cost competitiveness, in particular due to the prolonged period of wage growth above that of productivity, also hinders the return to a sustainable growth path. The general government balance deteriorated considerably in 2008 and turned to deficit, following six years of surpluses. According to the programme the general government is expected to be in deficit also in 2009 and 2010, with the deficit gradually declining. Taking into account macroeconomic risks and the lack of information on expenditure-based consolidation in 2010, the budgetary outcomes are subject to downside risks, with the headline deficit possibly exceeding the 3% threshold in 2009 and 2010. In light of the existing imbalances, the planned restrictive fiscal stance from 2009 until 2011 is an appropriate response.

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:

(i) strengthen the consolidation of public finances in the short term to keep the general government deficit below 3% of GDP and take necessary measures to underpin the consolidation in the medium term;

(ii) implement prudent public sector wage policies to support the adjustment of the economy and to strengthen competitiveness;

(iii) reinforce the medium-term budgetary framework, particularly by improving expenditure planning and efficiency.

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[5] 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.

Comparison of key macro economic and budgetary projections

		2007	2008	2009	2010	2011	2012
Real GDP (% change)	**CP Nov 2008**	**6.3**	**-2.2**	**-3.5**	**2.6**	**4.8**	**5.0**
	COM Jan 2009	6.3	-2.4	-4.7	1.2	n.a.	n.a.
	CP Nov 2007	*7.4*	*5.2*	*6.1*	*6.7*	*7.0*	*n.a.*
HICP inflation (%)	**CP Nov 2008**	**6.7**	**10.6**	**4.2**	**2.8**	**3.0**	**3.2**
	COM Jan 2009	6.7	10.6	3.2	2.7	n.a.	n.a.
	CP Nov 2007	*6.6*	*8.6*	*5.6*	*3.6*	*3.5*	*n.a.*
Output gap[1] (% of potential GDP)	**CP Nov 2008**	**8.0**	**0.9**	**-5.7**	**-5.9**	**-3.9**	**-1.7**
	COM Jan 2009[2]	9.0	2.1	-5.4	-6.4	n.a.	n.a.
	CP Nov 2007	*2.7*	*0.1*	*-1.2*	*-1.5*	*-1.3*	*n.a.*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**CP Nov 2008**	**-16.9**	**-10.5**	**-5.1**	**-5.0**	**-4.7**	**-4.7**
	COM Jan 2009	-17.1	-8.8	-4.2	-2.6	n.a.	n.a.
	CP Nov 2007	*-14.0*	*-9.9*	*-8.2*	*-7.8*	*-7.4*	*n.a.*
General government revenue (% of GDP)	**CP Nov 2008**	**38.2**	**36.2**	**38.9**	**37.8**	**36.5**	**35.2**
	COM Jan 2009	38.2	36.5	38.2	38.4	n.a.	n.a.
	CP Nov 2007	*37.2*	*38.2*	*38.2*	*37.4*	*36.3*	*n.a.*
General government expenditure (% of GDP)	**CP Nov 2008**	**35.5**	**38.2**	**40.6**	**38.8**	**36.4**	**35.0**
	COM Jan 2009	35.5	38.5	41.4	41.6	n.a.	n.a.
	CP Nov 2007	*34.6*	*36.9*	*37.2*	*36.5*	*35.5*	*n.a.*
General government balance (% of GDP)	**CP Nov 2008**	**2.7**	**-1.9**	**-1.7**	**-1.0**	**0.1**	**0.2**
	COM Jan 2009	2.7	-2.0	-3.2	-3.2	n.a.	n.a.
	CP Nov 2007	*2.6*	*1.3*	*1.0*	*0.9*	*0.8*	*n.a.*
Primary balance (% of GDP)	**CP Nov 2008**	**2.9**	**-1.8**	**-1.5**	**-0.8**	**0.3**	**0.4**
	COM Jan 2009	2.9	-1.8	-3.0	-2.9	n.a.	n.a.
	CP Nov 2007	*2.7*	*1.4*	*1.1*	*1.0*	*0.8*	*n.a.*
Cyclically-adjusted balance[1] (% of GDP)	**CP Nov 2008**	**0.3**	**-2.2**	**0.0**	**0.8**	**1.3**	**0.7**
	COM Jan 2009	-0.1	-2.6	-1.6	-1.3	n.a.	n.a.
	CP Nov 2007	*1.8*	*1.3*	*1.4*	*1.3*	*1.2*	*n.a.*
Structural balance[3] (% of GDP)	**CP Nov 2008**	**-0.1**	**-2.4**	**-0.1**	**0.4**	**1.2**	**0.7**
	COM Jan 2009	-0.4	-2.8	-1.6	-1.3	n.a.	n.a.
	CP Nov 2007	*1.2*	*0.8*	*1.4*	*1.3*	*1.2*	*n.a.*
Government gross debt (% of GDP)	**CP Nov 2008**	**3.5**	**3.7**	**3.7**	**3.5**	**3.0**	**2.8**
	COM Jan 2009	3.5	4.3	6.1	7.6	n.a.	n.a.
	CP Nov 2007	*2.7*	*2.3*	*2.0*	*1.8*	*1.6*	*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 4.6%, 4.1%, 3.7% and 3.5% respectively in the period 2007-2010.

[3] Cyclically-adjusted balance excluding one-offs and other temporary measures. One-offs and other temporary measures are 0.4% of GDP in 2007, 0.2% in 2008, 0.1% in 2009, 0.4% in 2010 and 0.1% in 2011; all deficit-reducing according to the most recent programme. One-offs for the period 2009-2011 are not considered to be of a one-off nature according to the Commission services' January interim forecast.

Source:
Convergence programme (CP); Commission services' January 2009 interim forecasts (COM); Commission services' calculations.