

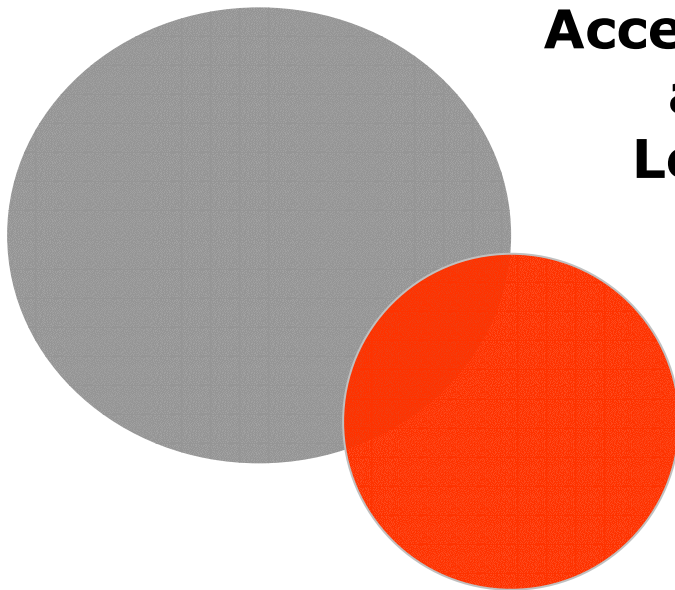


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Open Society Institute - Sofia

Country Report ESTONIA

Economic and Political Challenges of Acceding to the Euro area in the post- Lehman Brothers' World



**Hardo Pajula,
OÜ Monadero**

Sofia, October 2009

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The publication is a product of the Open Society Institute – Sofia within the European Policies Initiative (EuPI) and the project “Economic and Political Challenges of Acceding to the Euro area in the post-Lehman Brothers’ World”.

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The publication comprised of nine Country Reports and a Summary Report is available on the website of the European Policies Initiative: www.eupi.eu

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The European Policy Initiative (EuPI) aims at stimulating and assisting the New Member States from CEE to develop capacity for constructive co-authorship of common European policies at both government and civil society level. As a new priority area of the European Policies and Civic Participation Program of Open Society Institute – Sofia, EuPI will contribute to improving the capacity of New Member States to effectively impact common European policies through quality research, policy recommendations, networking and advocacy.

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EuPI aims at stimulating and assisting new Member States from CEE to develop capacity for constructive co-authorship of common European policies at both government and civil society levels (www.eupi.eu).

The project was implemented from September 2008 to September 2009. The main outcome of the project is a publication comprised of nine Country Reports and a Summary Report.

Following a uniform structure, and addressing a set of similar questions, the nine Country Reports (Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania and Slovenia) present stylized facts about the patterns of real and nominal convergence with the euro area in nine new EU members, outline the setting and the implementation of the accession policies in those countries and emphasize the incidence of the current crisis on the strategy to adopt the common currency.

Comments are relevant to policy developments until 20 May, 2009 – the cut-off date for the submission of the last revised version of the Country Reports.

The Summary Report reviews the results of the Country Reports and systematizes some of the dominant trends they reveal. The Summary Report checks the countries’ experience in dealing with the complicated concentric monetary structure inside the EU (euro area; ERM II; non ERM II countries) and pays particular attention to the evidence gathered about the political economy of the procedures in the different countries.

Each Country Report and the Summary Report include an Appendix, containing Tables that summarize significant data provided in accordance with a standardized set of indicators.

The results of the Project are correctly intelligible only if all its pieces (ToR, Summary Report, Country Reports, Appendix) are considered together.

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The project was able to benefit from the insights of a distinguished Advisory Board. As the Boards’ mandate was limited to advice and comments on the methodology and the Summary report, responsibility for the findings and statements rests solely with the authors of the Country and the Summary reports.

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EXECUTIVE SUMMARY

This paper deals with the Estonian experience in dealing with the issues related to euro area accession. The work consists of three major parts. The first introductory part provides a concise summary of the trends in real and nominal convergence. We shall first find that, according to the International Monetary Fund (IMF), Estonian GDP per capita increased at an average yearly rate of 9% over fifteen years until 2008, thus registering one of the highest convergence speeds among the 173 countries in the IMF's *World Economic Outlook* database. We then approach the convergence process from three different angles: balance of payments (which are shown to be crucial) and monetary developments, labour market and price trends, and trade performance. The last subsection deals with the post-*Lehman* developments.

The second section lays out national goals and strategies for euro adoption. It consists of two subsections. The first concentrates on the experience before the global financial crisis. It mostly uses the government's convergence reports to assess the consistency, viability and efficiency of the euro-oriented steps. Particular attention is given to fiscal policy, it will be shown, how the gradual loosening of budgetary discipline in good times led to the formation of a massive structural deficit whose magnitude became apparent only when the demise of *Lehman Brothers* in September 2008 caused almost all activity indicators to nosedive and dealt a severe blow to government revenues.

The third part analyses the institutional and policy environment as it relates to euro adoption, with particular regard for the interactions of the key players in the negotiations. The key theme is relations between the national government on the one hand and Brussels and Frankfurt on the other. This section draws primarily on the convergence reports prepared by the European Commission and the European Central Bank (ECB). The frame provided by the convergence reports is now and then animated with the personal recollections of the people involved in negotiations.

The last part draws conclusions and offers a few policy recommendations.

I. Estonia's Economic Convergence

According to the IMF, Estonian GDP per capita increased from 5,734 in 1993 to 20,754 current international dollars in 2008, indicating a staggering 9% average yearly growth rate. Out of 173 countries for which we have data in the World Economic Outlook database, the cited growth rate was the eighth highest¹. If we limit our sample to the 30 countries whose initial per capita income was in the USD 5,000-10,000 bracket, Estonia would have the highest convergence speed ahead of Trinidad and Tobago, Lithuania, Botswana, Slovak Republic and Poland. This economic advance has been stable and strengthening (up until 2008) with the average growth rate increasing from 8.4% in 1993-98 and 9.0% in 1998-2003 to 9.4% in 2003-08. The golden period of convergence was the five years until 2006 when the growth rate amounted to 11.4%. The price level – as measured by the GDP deflator – has risen even faster over the same period (i.e. 1993-2008) – by 11.1%. Here the convergence is much more unevenly spaced on the time scale with most of the price adjustment occurring in the first phase of reforms; in 1993-98 the price level increased at an average rate of 22.1% per year. In the next five year period prices rose by 5.0% per year; the last five years saw price pressures increase with the average growth rate edging up to 7.0%.

Looking at the convergence in a European context, we see that the aforementioned growth rates have lifted Estonian per capita GDP from roughly two-fifths of the EU-27 average in 1998 to two-thirds in 2008. In the best period of 2001-06 the per capita output level converged from 46% to 65% of the EU-27 average. The price level that had reached 57% of the EU-27 average in 1999 jumped to 61% two years later, advanced to 65% in 2005 and then undertook another spurt to 72% in 2007 (the last year for which we currently have data).

In this eight-year period until 2007, Estonian real GDP growth rates never fell below 6% and averaged 8.2%. These were generally good years for Europe as whole (2001 and 2002 notwithstanding). Even then, fast converging Estonia was able to maintain a growth premium of 5.8% over the EU-27 average (see chart 1). Part of the reason may have to do with Estonia benefitting from being a member of the fast developing Baltic Rim region² which was itself able to keep a positive growth differential over the EU-27 in all the years since 1999 (with the average difference being 1.0%).

Balance of payments and monetary developments

If we look at the balance of payments developments – which for the miniscule economy like Estonia are of utmost importance – we see that Estonia started in 1999 from a situation that was probably not very far from equilibrium (see chart 2): in 1999-2001 the average current account deficit was 5.0% of GDP. This was, in turn, conditioned by relatively modest (relative to what would soon follow) capital inflows: in the same three year period the average yearly influx was just EUR 400m. This started to change in 2002, as the yearly financial and capital account surplus increased from roughly EUR 300m in 2001 to EUR 1.3bn in 2005, the current account deficit widened from 5.2% to 10.0%. But that was just the beginning of the party; in 2007 the capital inflows were up to EUR 2.7bn which brought the current account balance down to –18.1%. The adjustment started in 2008, with capital inflows coming down to EUR 2.1bn and current account deficit narrowing back to single-digit territory (9.2%).

¹ After Equatorial Guinea, Armenia, China, Myanmar, Latvia, Azerbaijan and Bolivia.

² Baltic Rim" is a constructed entity consisting of nine countries: Denmark, Estonia, Finland, Latvia, Lithuania and Sweden are included in their entirety. Germany, Poland and Russia are represented by their administrative units on the Baltic Sea. The combined population of the region is 46m and output USD 1300bn (PPP).

The structure of capital inflows reveals the significance of 2005 (see chart 3). Before that year most of the financing had occurred through foreign direct investments which in 1999-2004 had brought in on the average EUR 400m per year. The one-off financing inflow related to the sale of the remaining shares of *Hansabank* in 2005 sent in FDI inflow to EUR 1.7bn in 2005. But this was almost exactly offset by the outflow on the portfolio account, so that the net inflow was due to a sharp increase in borrowing from parent banks. In 2005-07 the borrowing from (mostly Scandinavian) financial institutions amounted to no less than EUR 6.3bn; and this was beyond doubt the single most important determinant of the economic environment of the boom years. By the same token, the drop in foreign borrowing from the peak of EUR 2.9bn in 2006 to EUR 0.7bn two years later, is the chief reason beyond the adjustment that has been on the way since Q1 2008.

Substantial capital inflows have enabled Estonia to accumulate international reserves (see chart 4). The official international reserves have increased from EUR 0.8bn in 2000 to EUR 2.7bn in 2008. Here the impact of the EU-accession is particularly visible, for the growth rate of international reserves, that in 2001-03 was slightly above 5.0%, went all the way up to 15.7% in 2004 and to 24.3% a year later. It stayed above 20% threshold until 2008 when it descended to 18.1%. Under currency board system there should, in principle, exist a one-to-one relationship between the growth of international reserves and base money. While the actual correlation is not perfect, the growth rates of M0 have indeed followed these of international reserves very closely. After having dropped by 3.0% in 2001, the growth rate of base money was up to 29.1% in 2005 and has since remained above 20%. To the extent that we have seen adjustment in 2008, it has been mostly in broader monetary aggregates which reflect banks' (or their customers') more cautious attitude towards lending and borrowing. Hence, the growth rate of M1 that had peaked at 32.6% in 2006 turned negative (-4.0%) two years later and, while the growth rate of M2 remained in positive territory in 2008, it has descended from 35.2% to 9.1%.

Vastly improved international liquidity promptly found its way into domestic credit expansion – the growth rate of domestic credit increased from an already solid 18.5% in 2002 to a giddy 41.1% in 2007 before easing back to 19.3% in 2008 (see chart 5). To the extent that, since 2002, deposits have grown at a slower rate than loans, the loan to deposit ratio has steadily climbed from 97.8% in 2002 to 174.2% six years later.

Labour market and price developments Basically the convergence process has been characterised by the directionally opposite movements of capital (in) and labour (out). While inflows of capital are relatively well documented, the outflows of labour are not. It is partly due to the geographic proximity of a major destination country – Finland. Whereas, for example, in neighbouring Latvia and Lithuania emigration took the form of people boarding aircrafts and heading for the UK or Ireland for a few months (if not years), in Estonia people were very often just commuting between Helsinki and Tallinn – the two cities that are gradually merging into one metropolitan area. Hence, already in 2005 the statistical office stopped keeping track of emigration and immigration flows because large discrepancies between Estonian and Finnish data sources demonstrated the difficulties of keeping track of people's movements.

While the exact numbers on emigration are thus not available, the impact of outflows upon the labour market is nevertheless clearly visible. One of the major impacts of the EU accession was a significant increase in labour demand. If in 2004 there was on the average of 596,000 people employed in the economy, then by 2008 this number had increased by 60,000 to 656,000 (consult chart 6). The employment growth rate that had dipped below

zero in 1999 and 2000 and in 2001-04 languished around 0% was up to 6.4% in 2006 when there were almost 40,000 new jobs created. The unemployment rate which in the aftermath of Russian debt crisis had climbed all the way to 13.6% in 2000 descended steadily to 4.7% in 2007 as the number of unemployed people declined from 90,000 to 32,000. By the first quarter of 2009, the number of unemployed had again reached 79,000, with the unemployment rate rising to 11.4%.

The described sharp rise in labour demand lifted the nominal wage growth rate from 7.8% in 2004 to an overwhelming 20.4% three years later (see chart 7). While price pressures remained by and large moderate throughout 2004-07, the 2007 credit explosion sent the consumer price index (CPI) growth rate to 6.6% in 2007 and 10.4% in 2008. As a result of these developments, the real wage growth rate was up to 13.0% in 2007 (from 4.6% three years earlier) before easing down to 3.1% in 2008.

Competitiveness and trade performance

While productivity did improve – in 1998-2007 it advanced steadily from 41% to 64% of the EU-27 average – from 2006 onwards it failed to keep pace with a rapidly expanding wage bill (see chart 8). Hence, the unit labour costs that in the eight year period prior to 2006 declined on average by 0.8% a year, were suddenly up to 9.3% in 2007 and further 9% a year later. The worsening of the competitive situation is also captured in the real exchange rate (CPI-deflated) movements; in the last two years the accumulated appreciation (7.7%) was only slightly lower than that which occurred over the preceding six years (8.7%).

The effect of adverse cost developments on foreign trade performance is obvious. In 1999, when the economy felt the full impact of the Russian crisis, exports contracted by 2.1%, then followed a strong rebound in 2000 when exports grew at the rate of 51.7% (see chart 9). This upswing was again cut short by the bursting of the technology bubble which slowed down the economic growth of the major trade partners – the growth rate of the Baltic Rim halved from 2000 to 2002 – and pushed the Estonian export rate yet again into negative territory in 2002. As the region's economic outlook improved from 2003 onward, Estonian export performance received a major boost. To the extent that positive income effects outweighed the rising costs, the growth rate of exports improved from negative 1.4% in 2002 to 32.8% in 2005. From then on, however, the cost effect seems to have taken over, for although the growth rate of the Baltic Rim region moved from 3.4% to 4.8%, the growth rate of Estonian exports declined to an admittedly still solid 23.6% in 2006. But when the cost effect was reinforced with income effect as the region started to cool in 2007, the growth rate of exports was quickly down to 4.1% in 2007. Irrespective of the still high export growth rate in 2006, economic expansion sucked in ever more imports so that the trade balance deteriorated by roughly EUR 1bn to EUR –2.5bn (in 1999 the deficit had been as low as EUR 0.8bn) and to EUR –2.7bn in 2007. As adjustment gathered momentum and the import growth stalled while in the first three quarters exports held up rather nicely, there was large EUR 1bn step towards external equilibrium in 2008.

After the global crisis

The impact of Lehman's demise is perhaps best encapsulated in the movement of confidence indicators (consult chart 10). Hence, the economic sentiment indicator that had trended downwards since September 2006 on the average by 1.3 points per month plunges from 89 points in August to 62 in March; that is roughly 3.8 points a month. But there are obviously much more than perceptions at play. Chart 11 shows that although the monthly capital inflows are very volatile so that clear patterns are somewhat difficult to establish, the

slowdown in external financing is nevertheless ascertainable. The outflow in November (EUR 268m) was the largest on record so far. If in the eight pre-Lehman months the average inflow had amounted to EUR 223m, then in the last six months this figure was down to EUR 90m. The activity indicators followed the inflows down. The industrial output that in April 2008 had still grown at a lethargic rate of 0.3% declined by 3.5% in August and plummeted by 30.6% in this February. Retail sales that in February had still increased by 6% were down by 5% in August and by 18% this February. The flash estimate of GDP put the rate of economic decline in Q1 2009 at 15.6%. On the other hand, the inflation that had been regarded as an enemy number one just a few quarters earlier has swiftly descended from its pre-*Lehman* (August 2008) 11.0% to 0.3% in April (Chart 12). On a month-to-month basis, consumer prices have fallen since October, with the accumulated drop being 2.7%. M1, whose growth rate turned negative in March 2008, has been declining ever since, with the y-o-y growth rate reaching -14.1% in this February. Altogether the narrow money supply has contracted by 14% since its peak in February 2008. The broad money (M2) has kept increasing but the rate of increase was down to 1.3% in this February (the all-time high was 45.7% in January 2006). It remains to be seen whether the increase in the growth rates of both monetary aggregates in March is a fleeting blip or the beginning of a new trend.

The growth rate of credit was down to 3.6% this March (from the last year's average of 19.3%), and the one of deposits to 5.5% (the last year's average was 11.3%). This March was the first month since October 2006 that deposits grew at a faster rate than loans. The ratio of loans to deposits has fluctuated around 175% since Q4 2007 (see chart 13). The elevated risk aversion is well documented in the time path of local currency interest rates (consult chart 14). The average kroon loan interest rate that in mid-2007 stood around 7.5% was up by almost 10pp a year later and reached 21.8% in this March. To the extent that euro loans have become cheaper over the last six months – from 6.0% in September 2008 to 2.6% in this March – the interest rate spread has risen from roughly 200bp in June 2006 to almost 2,000bp. At the same time, the share of overdue loans that had averaged to 293bp in 2004-07 shot up from 445bp to 1,106bp in this February before falling slightly to 1,024bp in March. The share of loans that have been overdue for more than 60 days has risen from its all-time low of 22bp in January 2007 to 424bp in this March – the highest value since August 1999.

In H2 2008 the adjustment reached the labour market as the number of the registered unemployed climbed from 17,000 in June to 30,000 by year end and then further to 61,000 this April (see chart 15). Unfortunately there are no wage statistics as yet for this year, but the data from 2008 shows that significantly fallen labour demand has taken the steam out of wage inflation. Thus, the growth rate of gross wages which in February 2008 still stood at 23% fell to 12% by the end of H1 2008 and came all the way down to 1.6% in December 2008. In the first months of the current year this figure has been almost certainly negative. The price and wages pressures of 2006-07 had caused a considerable real appreciation; if in December 2005 the real exchange rate had actually depreciated on a year-on-year basis, then in January 2008 the rate of appreciation had risen to 6% (see chart 16). Irrespective of large depreciations by important trade partners (notably Russia and Ukraine) the rate of appreciation has since then decreased to 1.2% in this April. As it was argued earlier, the cost pressures of 2006-07 did not initially affect export growth, which over seven quarters to September 2008 averaged 5.9%. The real shock arrived in Q4 2008 which brought the export growth rate down from 25.1% in September 2008 to -16.2% only two months later and to -28.1% in this January. In view of the rapidly contracting domestic demand, the growth rate of imports has fallen even more: from 7.3% in July 2008 to -36.5% in this January. As a result of rapidly declining imports, the monthly trade deficit (which in 2007 had averaged EUR 285m) was down to EUR 70m this February.

The declining activity and import growth rates have taken a heavy toll on government finances. The y-o-y growth rate of tax revenue to central budget that had hovered around 20% in the three years to 2008 was suddenly down to -8.1% in February 2008 (consult chart 17) and although it recovered later to 13% in July, it plunged back into negative territory in December (-15.4%) and has remained there throughout Q1 2009. The income base of the local budgets has proved to be somewhat sturdier, the growth rate became negative only in this January (-6.1%) and climbed back to positive side in the following month – if only marginally so. The radically changed government revenue situation has in turn triggered a series of adjustments in economic policy which form the substance of the following two subsections of this paper.

II. National Goals and Strategies for the Euro Adoption

To the extent that there exists a myriad of documents spelling out the government's intentions vis-à-vis the economy, it is not a straightforward exercise to summarise national economic policies in a way that would be comprehensive and meaningful at the same time. At the same time, the limited scope of this report forces our hand in choosing the most relevant set of documents. We are aware that in so doing we overlook a great deal of other important policy guidelines which have via less direct channels affected Estonia's convergence with the euro area.

The most significant document in the arena of euro adoption is certainly the convergence report which is prepared jointly by the ministries of finance and economic affairs in cooperation with the Bank of Estonia. This program departs from goals and policies that have been laid out in the European Stability and Growth Pact, *Success Estonia 2014* – a government blueprint for achieving the goals established by the Lisbon strategy – and successive coalition treaties. It is also consistent with the country's medium-term budget strategy. So far Estonia has had six convergence programs – or perhaps more correctly – one convergence report and its five successive upgrades. The first convergence program was adopted in May 2004; the upgrades followed in November 2004, December 2005, November 2006, November 2007 and December 2008. In what follows we make an overview and comment on successive convergence reports with the objective of showing how policymakers' priorities as they relate to euro area accession have shifted from May 2004.

Before the global crisis

Preparations for the changeover date started after the government's session on 15 January 2004 when the cabinet set the goal of being technically ready for the switch by the mid-2006 which would have enabled the country to adopt the common currency from 1 January 2007. The first convergence program was written with that objective in mind. Insofar as economic policies are ultimately shaped by politicians, it is important to keep in mind that the preparations started under the government of Juhan Parts. The three-party coalition consisted of the prime minister's own *Res Publica* – a relatively ideology-free party of young administrators with predominantly liberal (Millian sense) leanings, the Reform party – notionally a centre-right, free-market liberal party – and the rural People's Union. Altogether the government represented three constituencies (which in the case of *Res Publica* and Reform party had a considerable overlap): employers and high-earning professionals (Reform party), the young and the ambitious (*Res Publica*) and the local governments' lobby³ (People's Union). In 2003 the general government⁴ raked in EUR 3.2bn and finished with an unprecedented large surplus of EUR 146m (1.7% of GDP) against the background of a 12.1% nominal growth rate. That enabled not only the young to become ambitious; the Reform Party got its income tax reductions, *Res Publica* hand-outs to large families and People's Union the goodies for rural mandarins.

Against this political constellation, the government's first convergence program from May 2004 made it clear that Estonia wants to join the ERM II right after the accession to the EU and to keep its currency board monetary arrangement (Rahandusministeerium 2004a)⁵. In

³ If we were to maintain that in 15 years of market-oriented reforms socialist collective farms had by and large mutated into local governments then it would be only a minor exaggeration.

⁴ The government of Juhan Parts entered the office in April 2003.

⁵ It was also the time of pre-ERM II negotiations. Taavi Veskimägi – the then finance minister – reminisces: „The negotiations revolved around the usual suspects (current account deficit, inflation etc). The entry level exchange

so doing it effectively gave up the monetary policy tool and committed itself to using fiscal and structural policy levers to steer the economy towards the euro area. It mentioned – as it will do in almost all succeeding reports – the gaping current account deficit (–9.7% of GDP in Q2 2004) as representing the major risk to be dealt with. However, it then proceeded to play down the risk – this was also to become a recurrent theme until very recently – by arguing that the external imbalance was not a sign of eroding competitiveness but – if anything – the opposite. The central argument was that the current account deficit was largely due to a negative income balance. This was in turn – so the argument went – driven by the high return on direct investments. The bookkeeping reality was indeed that the reinvested profits of foreign parents were shown as negative income on the current account and positive inflows on the capital account, although no funds crossed the borders. As far as structural policies were concerned, the report mentioned another theme that will reoccur in all subsequent reports: the necessity of closing the gap between employment and education structures through the development of relevant labour market infrastructure. In order to move closer to that goal, the report stated the objective of lowering the labour's tax burden through income tax cuts (the central tenet of the Reform party). The only area where the government could foresee problems with fulfilling the Maastricht criteria was the moving target of price stability. In order to manage the price pressures that were concomitant with convergence process, the government emphasised the necessity of controlling administrative price hikes and keeping budget policy on conservative course. The report also pronounced the need of changing the guidebook of the local governments' finances which had added to overall deficit in the last years.

As 2004 drew to a close, the government prepared the next report (in November, Rahandusministeerium 2004b). By this time it must have been clear that public finances were in good shape (nominally at least). Indeed, the general government collected EUR 3.4bn in revenues and ended up with a EUR 160m surplus (1.7% of the GDP). Compared with what was to follow, however, the 8% increase in general government budget was very modest, even if social spending had increased by 16.4% against the last four-year average of 7.7%. The report that came out in November referred to increasing price pressures. Indeed, the y-o-y inflation was up from 0.4% in Q1 2004 to 4.0% two quarters later, but these adverse developments were initially blamed on the accession-driven one-off increases in the excise taxes on alcohol and tobacco and on the harmonisation of the EU's tariffs. Insofar as the actual GDP growth was estimated to fall short of the potential, the general government's nominal budget surplus was considered to strongly anticyclical and the government set out the three-year plan of reducing the tax burden for enterprises and households while shifting the tax load increasingly from labour and capital income towards consumption and pollution. The report also emphasised the goal of keeping public sector's weight in the economy constant.

The year that followed turned out to be crucial in terms of political developments and – quite possibly – also in terms of missed euro accession. The three-party alliance had been an uneasy one from the very beginning. Firstly, there was widening gap between the freewheeling budgetary priorities of the People's Union on the one hand and the more orthodox fiscal attitudes of the Reform party and *Res Publica* on the other. Secondly – and in view of the later developments more crucially, the rivalry between Reform party and *Res Publica* intensified as the popularity of the prime minister sank. The two parties that in the early 2004 had considered joining their ranks became mired in internecine quarrels after the Reform party's former chairman Siim Kallas left for Brussels in the spring of 2004 and Mr Andrus Ansip rose to the helm of the party. As the popularity of the *Res Publica* – which had

rate was a matter of discussion. In particular southern member states questioned the survivability of the current exchange rate. But we were supported by the Commission and the ECB and joined at the unchanged rate."

swept into the office in 2003 with promises of cleaner and corruption-free politics – was languishing at below the election threshold in the spring of 2005, Mr Ansip seized his chance, swapped the hapless *Res Publica* for the Centre party of Mr Edgar Savisaar and became the prime minister in what many pundits interpreted as a government of Messrs Savisaar and Reiljan (the chairman of the People's Union). This assertion is by no means far-fetched, for Mr Savisaar – whose Centre Party is playing for the gallery of the elderly, Russian-speakers and low-earners – and Mr Reiljan were indeed naturally born allies whose negligence for fiscal discipline became increasingly apparent. Thus, 2005 was the last year for which the government of Juhan Parts had drawn the budget. For that year the general government revenues amounted to EUR 3.9bn, an increase of 14.2% over the previous year. Although social spending grew in that year at a slower rate (13.1%) than revenues, the signs of more expansionary fiscal policy were clearly visible in the surplus which was roughly the same as in the previous year (EUR 166m). However, set against the GDP, the surplus had nudged down to 1.5% just as nominal economic growth had moved from 11.0% in 2004 to 14.9% in 2005.

In the report that came out in November 2005 the government drew attention to surfacing imbalances and risks that had to be addressed (Rahandusministeerium 2005). Although the y-o-y credit growth rate had stayed in the range of 35-40% since Q1 2004, the unremitting expansion was proceeding from increasingly higher base so that the level started to matter. The report also showed that the government had started to worry about becoming a member of the euro area as quickly as possible in order to minimise the emerging risks and provide for greater stability. The government declared its determination to counter the new set risks with conservative fiscal policy and a lower pace of administratively regulated price hikes. In particular, the report emphasised the importance of pension reform in handling the impact of negative demographic tendencies upon the sustainability of government finances.

In order to counter the risks associated with the fast credit growth, big current account deficit and the higher wage pressures – another negative development brought up in this report, the government came up with a list of policy measures to contain the intensifying demand pressures. It decreased the maximum home mortgage interest tax deduction; thereby effectively raising the real after-tax interest rate for the new borrowers. The government also limited the circle of people eligible for housing loan guarantees granted through the *Kredex* agency. The Bank of Estonia raised the commercial banks' reserve requirement to 13% and the central government reduced domestic liquidity by withdrawing its deposits from Estonian banks (the overall decline in government's deposits being equal to 1.5% of GDP).

The 2006 budget was the first for Mr Ansip's government to compile. The environment could not have been more auspicious. The nominal growth rate of GDP reached an all-time high of 18.2% for that year, general government revenues increased by almost EUR 1bn to EUR 4.8bn and the surplus reached EUR 435m (3.3% of GDP), even as social spending increased by 14.9%. The convergence report from December 2006 added the real estate market to the list of ailments vexing the economy (Rahandusministeerium 2006). It also stated that insofar as Estonia was not able to meet the price stability criterion, the government had to postpone the changeover date from 1 January 2007 to 1 January 2008. Overall, the report put on a brave face in the light of accumulating troubles. It said that insofar as markets had taken the postponement of the accession date quite calmly, the country would have to stick to its credible set economic policies and try to join the euro area as soon as all the convergence criteria are fulfilled. In order to alleviate the demand strains, the government further cut the maximum home mortgage interest tax deduction, whereas the Bank of

Estonia raised the required reserve ratio from 13% to 15% and tightened regulations for issuing home mortgage loans.

2007 was an election year and fiscal developments clearly reflected this political reality. Although the nominal growth rate eased somewhat to 16.5%, the conditions for budgetary largesse continued to be extremely favourable, as general government's total revenue increased by another EUR 1bn to EUR 5.8bn. The surplus contracted, however, to EUR 412m (2.7% of GDP), while social spending increased by a record 18.3%. The tone of the convergence report from November 2007 had already changed quite perceptibly (Rahandusministeerium 2007). The government cited the first signs of adjustment, particularly in credit growth and real estate market activity. The report also mentioned the gathering clouds in the international financial markets. Due to the first signs of stress, the government underscored the necessity of maintaining competitiveness through moving the resources towards high-value added sectors. In order to promote the needed structural adjustment, the report referred to a new draft of labour contract law aimed at reducing the remaining market rigidities while improving the social safety net. The government restated its commitment to conservative fiscal policy and cited the expected surplus of 2007 (2.6% of GDP) and the planned surplus of 2008 (1.3% of GDP) as proof that it is still following this course. As far as the timing issues were concerned, the government gave up the fixed target for the changeover date (due to its inability of forecasting the future price developments). At the same time, however, it also shifted the excise tax hikes planned for 2009-10 to 2008 when the meeting of the inflation target was impossible anyhow. By changing the time path of administrative price increases, the government hoped to improve the probability of meeting the Maastricht inflation target in the future.

After the global crisis The stage for the troubles that came to haunt the economy in the late Q3 2008 were set long before Lehman bankruptcy on 15 September 2008, in preparation for the 2008 budget which started almost immediately after the general elections in March 2007. The mood of the 2007 parliamentary elections was well captured by the Financial Times just a night before polls:

Extravagant promises, optimistic forecasts and a glowing view of the future have characterised campaigning ahead of tomorrow's parliamentary elections in Estonia.

Buoyed by an economy that is growing nearly 12 per cent a year, the leaders of the two main parties [Mr. Ansip's Reform party and Mr. Savisaar's Centre Party, H. P.] are making bold promises.

The centre-right Reform party is claiming that Estonia can be one of the EU's five richest countries in 15 years, while the left-leaning Centre party has promised to double pensions and treble public sector salaries.⁶

The biggest winner of the elections was the prime minister's Reform party which had 27.8% of the votes against his nemesis Mr Savisaar whose Centre party was with its 26.1% a close second. To the extent that his former coalition partners lost six seats between them, Mr Ansip was able to put together a new coalition consisting of his Reform party, the Union of

⁶ „Estonian politicians ride the wave of optimism ahead of polls.“ Available at http://www.ft.com/cms/s/0/8a42160c-c92e-11db-9f7b-000b5df10621.html?nclick_check=1 (accessed on 17 May 2009).

Pro Patria and *Res Publica* – who had ended up as the biggest losers of the election – and social democrats.

The extravagant optimism of the new coalition extended well into 2007. Although by Q2 2007 the y-o-y real GDP growth rate had descended to 6.7% from its peak of 11.0% in Q1 2006, the ministry of finance forecasted a 13.9% nominal growth rate for 2008 in March (against 16.5% achieved in 2007). In the next forecast that came out on August 21, the ministry raised its nominal growth forecast to 14.5%.⁷ The budget for 2008 was thus prepared on these premises. To the extent that we do not have as yet the actual data on 2008 general government finances, we have to be content with the central government budget figures. The parliament passed the budget law for 2008 on 12 December. The traces of extravaganzas were all over the document. The government projected the revenue of EUR 6.2bn (up EUR 1.3bn or 27% from 2007), with the budget of the social affairs ministry increasing to EUR 2.6bn from EUR 1.9bn a year earlier. Thus, the post-election budget turned out to be more devastating than the pre-election one which saw the projected revenues to rise from EUR 3.9bn to EUR 4.9 (so that in two years the central government's budget revenues increased by no less than 57%!).

In December of 2007, however, everything seemed to be in the best order: the central government's budget revenue increased by 26.5% – well above the last seven year's average of 15.1% – and the parliament had just approved the supplementary budget in which it allocated EUR 396m of unbudgeted revenues to EUR 173m of additional expenditure (of which social affairs ministry received EUR 141m) and EUR 224m to stabilisation reserve. The moment of reckoning came two months later in the last week of March 2008. Just three days after he had stubbornly denied any problems with revenue collection, the prime minister was forced to admit on 27 March that cost cutting is unavoidable. By that that he had obviously been briefed about fiscally dismal February – central government's revenues were down by 8.1% (y-o-y). However, the finance ministry's so called "spring forecast" that came out a week later on 3 April had trimmed the 2008 nominal growth estimate just by 2pp to 11.9% whereas the projected 2009 nominal growth rate had effectively remained unchanged at 12.2% (compared with 12.6% in the previous forecast).

One and half months later on 15 May 2008 – in March the central government's revenues had increased by 5.6% y-o-y, a far cry from which was planned – the government approved the project of a supplementary budget which knocked off EUR 390m from revenues and EUR 205m from expenditures. In a run up to the budget proceedings of 2009, the finance ministry came out with its autumn forecast on 25 August 2008⁸. This document struck a considerably bleaker tone than its cheerful predecessors, as the nominal growth estimates for 2008 and 2009 were trimmed to 7.8% and 7.9% (from 11.9% and 12.2% respectively).

However, as we know now, even this small step towards reality failed to catch up with the events. On 15 September 2008 *Lehman Brothers* filed for bankruptcy protection and by the time Ansip's government sent its 2009 budget to the parliament on 25 September, the TED spread had widened to 300bp and the latest statistics showed that August revenues had increased by paltry 4.2%. Against this extremely unpromising environment the projected budget figures made again for uplifting reading; revenues were to stay at EUR 6.2bn (no increase compared with the *ex ante* budget of 2008, but an hefty 6.3% rise if the cuts embodied in the supplementary budget are taken into account), of which social affairs ministry claimed EUR 2.8bn (up by EUR 200m).

⁷ As the irony would have it, the TED spread which since the beginning from 2002 all the way up until August 2007 had fluctuated around the average of 29 basis points was up to 222 bp on 20 August of 2007.

⁸ By that time the TED spread had eased to around 100bp.

The shockwaves that emanated from *Lehman's* failure, forced the finance ministry to revise its forecasts yet again in the autumn (the regular procedure is to prepare the spring and summer forecasts). By the time new set of forecasts came out on 27 November, the government knew that its revenues had shrunk by 4.7% in September and finally succumbed to reality as the 2009 projected nominal growth rate was slashed to 0.8%. The new convergence report appeared on 4 December (Rahandusministeerium 2008). It downplayed problems by stating that, although the external risks had risen substantially, the accumulated imbalances had also subsided and adjustment process was gathering momentum. The theme that appeared for the first time in 2007 report – the need for improved regulation of financial intermediaries – is there again, coupled with calls for lower credit growth and more moderate wage hikes. On a positive note, the report said that the probability of meeting the Maastricht inflation criterion had unexpectedly risen and the government was once setting its sights on 2010-11 as the possible period of entry. At the same time, the government also attributed greater importance to the euro accession due to the rapidly risen external risks.

In order to facilitate the necessary structural changes towards higher-value added activities and greater international competition, the government referred to the newly created Development Fund which was charged with risk capital investments into technology-based Greenfield companies. In order to oppose the financial disintermediation due to swiftly risen risk aversion, the authorities also promised to come up with measures of financial support for the enterprises, should the need for that arise. The primary source of funds for that purpose was deemed to be the European Union. Another policy initiative that was directly dictated by the imperatives of the post-*Lehman* world was of course the deposit guarantee scheme that protected all of the first EUR 50 000 of households' and small and medium-size enterprises' savings.

One of the central themes in the last convergence report was labour market flexibility. Although the new labour contract law was initially to take effect from 2010, given the urgency of the situation, the date of its inception was brought forward to 1 July 2009 so that it would support the labour market during the forthcoming stress. In order to increase labour market flexibility, the new law made dismissal procedures easier by reducing the term of advance notice by 30 calendar days to between two weeks and three months, depending on the length of the previous employment contract. To ease the financial burden of redundancies for the employer, the payment of redundancy benefits was shared by the employer and the Estonian Unemployment Insurance Fund. In all redundancy cases, the employer will pay a proportion of the redundancy benefit amounting to one month's average wage of the employee, while the Unemployment Insurance Fund will finance the remainder. To improve social security, the unemployment insurance benefit was to be raised from 50% to 70% of the previous average remuneration during the first 100 days of unemployment, and from 40% to 50% after that period. Under the tripartite agreement, a number of other changes were also introduced to the labour market. These include changes in the regulation of labour dispute committees, measures concerning lifelong learning, such as annual study leave and taxation of expenses on employee education, along with administrative procedures, working time regulations and reform of labour market institutions.

As 2008 drew to close, the policymakers learned that after the budget revenues rebounded by positive 7.5% in October, a month later the growth rate was down to a miserable 2.8%. Then came the dismal January and the severity of the downturn became gradually apparent. The ministry of finance reported on 14 January that according to preliminary data the budget revenues of 2008 had amounted to EUR 5.4bn (94.1% of the budgeted intake) and that deficit of EUR 332m was financed out of accumulated reserves. It also turned out that revenues had fallen by 15.4% (y-o-y) in December. On 6 February, the ministry reported

simultaneously that the January tax revenues had fallen by another 15% and that the coalition had reached an understanding on further budget cuts in the magnitude of EUR 511m. Less than two weeks later, on 18 February, the government had already sent a supplementary budget to parliament. The projected revenues were shaved to EUR 5.6bn (a roughly 10% cut) and expenditures to EUR 5.9bn (-6.5%). The ministry of social affairs outlays were brought back to the level envisaged in the 2008 budget (EUR 2.6bn), as the rate of planned pension increases was reduced from 14% to 5%. In order to stem deficit spending, local government imposed a new set restrictions on their financing activities effective from 1 March.

III. Institutional and Policy Environment Regarding the Euro Adoption

The last section of the report deals with the political economy of euro accession, i.e. with the interactions of the key players in the negotiations. The central theme of the section is of course the relations between national government on the one hand and Brussels and Frankfurt on the other. If the previous section looked at the policy issues from the government point of view, then this approaches the accession from the opposite side. To preserve the symmetry, we use yet again the convergence reports as our main source of reference; this time they are, however, not the reports prepared by the national authorities but by the European Commission and European Central Bank respectively. The status of these documents is commonly known; both institutions have been given the mandate to report to the Council of the European Union at least once every two years on the progress made by the member states towards the achievement of economic and monetary union. Altogether there have thus been two convergence reports (one from each) in three years: 2004, 2006 and 2008.

In what follows we shall overview and analyse the reports of the two key institutions of the EU. While the survey of the six aforementioned convergence reports will constitute the frame section, we shall try to add some flesh and blood to the skeleton by peppering this account – where relevant – with anecdotal evidence on the actual state of negotiations picked from the press releases of the related institutions, from media or personal reminiscences of the negotiators. Although we shall concentrate on the Tallinn-Brussels axis, we shall also be on the lookout for discords as they emerge between the two key national policymaking bodies: the government and the Bank of Estonia.

Before the global crisis

Three days after the accession date on 4 May 2004 *Financial Times* reported:

Four of the 10 new European Union members could take the first step towards joining the euro by the end of the year, with the aim of adopting the single currency in 2007. Cyprus, Estonia, Lithuania and Slovenia have indicated they could join the Exchange Rate Mechanism 2 – the waiting room for the single currency – later this year, the European Commission said. That means they will have to fix their currency against the euro within a fluctuation band of 15 per cent, as part of their preparations for joining the euro. If they also comply with the other membership criteria, including cutting national debt, controlling deficits and inflation and giving full independence to their national central banks, they could join in 2007. A spokesman for Joaquin Almunia, the new EU monetary affairs commissioner, said the timetable for entry set by all the new members was "realistic".⁹

Less than two months later on 28 June, Estonian kroon, Lithuanian litas and Slovenian tolar were indeed included in the ERM II. A press release of the ECB from 27 June explicitly stated that the agreement on participation was "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

⁹ „Four new EU states signal interest in joining euro“. Available at <http://search.ft.com/ftArticle?queryText=the+timetable+for+entry+set&aje=true&id=040503006055&ct=0> (accessed on 17 May 2009).

EU bodies, and they will strengthen the fiscal stance if warranted.”¹⁰ To put these figures in a perspective: at this time the quarterly public balance had fluctuated around positive 2% of GDP, whereas the current account deficit had mostly stayed in the 10-12% (of GDP) corridor.

The first convergence report covering Estonia came out in October 2004 (Commission of the European Communities 2004). The one from the European Commission was rather succinct in concluding that insofar as Estonia does not fulfil legal compatibility and exchange rate stability criteria, there should be no change in its status as a “Member State with a derogation”. The ECB’s counterpart was somewhat more thoroughgoing and brought up a number of key issues that would recur in the subsequent reports in 2006 and 2008 (European Central Bank 2004). It crucially acknowledged that the observed process of disinflation which had brought HICP annual increase down from 19.8% in 1996 to 1.4% in 2003 reflected the orientation of monetary policy towards the achievement of price stability through the adoption of a currency board arrangement in 1992. The snag here is that – as we shall see later – the very institution that enabled Estonia to achieve relative price stability after 1992 became inadequate in eradicating the residual inflation from the system in the face of massive capital inflows that the EU accession brought in its wake. The report also anticipates one of the key issues in the later negotiations by saying that the catching-up process is likely to influence inflation in the coming years but adds then that “the exact size of the impact is difficult to assess.” Regarding long-term interest rate developments, the report conceded that due to very low public debt ratios, the Estonian financial system does not have a well-developed market for long-term government local currency denominated bonds and consequently, a harmonised long-term interest benchmark is not available for Estonia. But, more importantly, it then concludes by saying that “considering the low level of government debt and on the basis of a broad analysis of financial markets, there are no indications suggesting a negative assessment”. Finally, in the field of legal compatibility, the report stated that four key pieces of legislation – the Act on the Bank of Estonia, the Constitution of the Republic of Estonia, the law on currency and the law on security for national currency – were not fully in line with the Treaty and the ESCB/ECB Statute and thus have to be amended.

Domestically the first signs of rift in the heretofore united position vis-à-vis the euro appeared in April of 2005 amid the new coalition talks. As it came apparent that the Centre party and the People’s Union were pressing for increase in basic pensions (amounting to around 0.5% of GDP), the Bank of Estonia warned on 6 April 2005 that insofar as the excessive government expenditure reinforces price pressures and exacerbates the already fragile external equilibrium, it may obstruct Estonia’s effort in meeting the Maastricht criteria. Since by that time the yearly average inflation had already risen above 4%, these concerns were not taken from thin air, but the incoming coalition remained unfazed. Moreover, the new minister of finance from People’s Union said on the very day of his inauguration that Estonia might use referendum to decide its participation in the euro area, although the accession treaty left the new member states no discretion in that area. “They [the Centre Party and People’s Union, H. P] were not really interested in the accession at all,” said one person who was closely involved in the negotiations. Although both prime minister and the Bank of Estonia quickly intervened by declaring that Estonia has no plans for the referendum, the new coalition’s ambivalent attitude towards the common currency was made clear from the outset.

As energy prices started their upward march – by August 2005 WTI Crude cost almost 40% more than at the beginning of the year – policymakers became increasingly reserved about

¹⁰ Available at http://www.ecb.int/press/pr/date/2004/html/pr040627_2.en.html (accessed on 17 May 2009).

the attainability of the price stability criterion. Both the ministry of finance and the Bank of Estonia admitted that their inflation forecasts had been based on a more moderate rise of energy prices and as a result the country may not meet the inflation target in the spring of 2006 and the changeover date on 1 January 2007 might have to be postponed. "I realised quite soon that we are not going to meet the inflation criterion," reminisces one of the Estonian negotiators who had joined the team in the spring of 2005. But the technical preparations continued unabated and on 1 September the government approved the plan of a changeover according to which the euro was to be introduced on 1 January 2007.

December 2005 was the first time that a political heavyweight articulated the doubts that Estonian lax fiscal policy is not consistent with the euro goal. In order to correct the course, the former prime minister Mart Laar called then for a decisive effort to cut the expenditure. But as late as on 31 December the vice-president of the Bank of Estonia still affirmed that the country is prepared to join in a year's time. A couple of weeks later, however, the prime minister already showed the signs of coming to accept the reality when he admitted that he did not intend to resign should the Estonia not be able to access the euro area on 1 January 2007 and continued that vibrant economic development was more important than the introduction of the euro. A few days later came the first clear sign of trouble when the Commissioner for Economic and Financial Affairs Joaquin Almunia announced in Brussels that with its current inflation Estonia were about to stay on the other side of the euro door. Finally, on 14 March the minister of finance admits that Estonia is not going to introduce the euro on 1 January 2007 as it will not be able to fulfil the inflation criterion, "I am not ready to sacrifice high economic growth to bring the inflation down," was the prime minister's terse response to the renewed calls from the opposition to step down because of the major policy failure.¹¹ When Eurostat reported in April 2006 that Estonia had the fourth largest budget surplus (in relation to GDP) in the European Union, the minister of finance used the opportunity for self-congratulation: "The fact that Estonia has one of the largest public surpluses in the EU, is the vivid sign of the success of our fiscal policy."

Once it became clear that the target has been missed, the policymakers started to set new deadlines. The Bank of Estonia came out with new relatively positive inflation forecast in April 2006. It argued that if the government were to postpone a new round of alcohol and tobacco excise tax hikes and energy prices do not surprise on the upside, it might be possible to fulfil the inflation criterion in H1 2007 and to become a member of the euro area from 1 January 2008. "As it became increasingly apparent over the course of 2005 that we are not going to meet the price stability target, we changed our negotiations tactics," recalls one of the members of the changeover team. The main thrust of the argument was that under a currency board system there is no real policy mix, as there is no control over domestic money supply and, consequently, over inflation. While Estonia exhibits price stability measured against its own turbulent standards – and is thus in keeping with the spirit of the Maastricht treaty –, it will not be able to meet the technical inflation criterion in the face of large capital inflows any time soon. Thus, Estonia launched a public relations campaign during which its diplomats tried to explain in European capitals that the technocratic interpretation of the price stability criterion would be unfair to rapidly converging economies. Their efforts did reverberate in the court of public opinion, e.g. in May 2006 no lesser figure than William Buiter wrote on the pages of *Financial Times*:

Forcing candidate countries to meet both an exchange rate criterion and an inflation criterion makes no economic sense. Neither the ECB nor the Bank of England attempts the impossible: to control both inflation and the exchange rate. Opting for stable exchange rates, the

¹¹ The fact that in March 2006 the introduction of the euro was supported only by 40% of the respondents may also have had something to do with this apparent nonchalance against the eurozone.

Baltic candidate countries have seen their inflation rates rise with energy price increases and impressive productivity gains in their traded sectors. The latter factor, which occurs as the candidate countries rapidly catch up with the eurozone, means that the relative price of non-traded goods rises faster than in the eurozone and is known as the Balassa-Samuelson effect.¹²

But the commission that had to balance the macroeconomic theory with the rule-bound behaviour, remained unconvinced. In a conference organised by the National Bank of Austria in May 2006 Joaquin Almunia reasserted:

As you know, the Maastricht Treaty requires Member States to achieve a high degree of nominal convergence on a sustainable basis prior to adopting the single currency. Satisfying the accession criteria requires a huge effort by all new Member States and considerable progress has been made in most countries thanks to the commitment of citizens and governments to making euro membership a top priority.

Three countries, Estonia, Lithuania and Slovenia, had originally aspired to adopt the euro on 1 January 2007. Last, month Estonia announced its decision to postpone its target date for euro-area entry to January 2008 having recognised that it was presently not fulfilling all the Maastricht convergence criteria. This decision is, I believe, a wise one. Establishing a new target date for euro adoption helps to focus the preparatory work and provides an anchor for economic policies. (Almunia 2006)

Summer of 2006 brought with it the first negative consequences of the failure to introduce the euro as both *Standard & Poor's* and *Fitch* trimmed Estonia's credit rating outlooks from positive to stable. The authorities, however, continued on a self-assured note. In June the minister finance met Joaquin Almunia who praised the state of Estonia's public finances but warned about excessive loan growth, labour market strains and associated wage pressures. The Economic and Financial Affairs Council did debate on the price stability criterion on 10 October in Luxembourg but while the press release on this meeting said that while the Council "held an exchange of views" on the topic, the conclusion that "fulfilment of all criteria and all obligations by a member state can allow it to join the euro area, as is currently the case with Slovenia, which will adopt the euro as its currency as from January 2007" meant that Estonia's efforts to push through a less rigorous interpretation of the had came to nothing. Two months later, the government admitted that Estonia will not be able to meet the inflation criterion during 2007 and as a result the official accession day will be shifted from 1 January to an unspecified date.

The ECB's convergence report from December 2006 mentions nascent capacity constraints and signs of labour market tightness in a number of sectors that had started to exert pressure on wages and prices (European Central Bank 2006). It warned that the observed labour market tensions might together with the one-off price shocks coming from energy prices, indirect taxes and administered price give rise to considerable second-round effects, which could then in turn translate into a more significant and protracted increase in wages and inflation. In order to prevent this from happening the ECB emphasised the dependency

¹² "Europe must relax its inflation test for euro entrants". Available at <http://www.ft.com/cms/s/1/e5aeb48-dacb-11da-aa09-0000779e2340.html> (accessed on 17 May 2009).

on a fiscal and labour market policies to contain demand-induced inflationary pressures. Moving then to the area of public finances, the report crucially pointed out that “there appears to be some risk of a fiscal loosening” and argued that the government’s strategy of targeting balanced budgets may not be sufficient to contain demand pressures in the economy. Finally, the ECB stated that after amendments with respect to the Act on the Bank of Estonia, the incompatibilities raised in the 2004 report have been removed and although Estonia’s constitution is not formally compatible with the requirements of the Treaty and the ESCB Statute, the ruling of the Estonia’s Supreme Court provided legal clarity and therefore removed the need for further amendment. Thus, subject to the repeal of the Currency Law and the Law on the Security of the Estonian Kroon effective from the date of the introduction of the euro, national legislation in Estonia was considered to be fully compatible with the Maastricht criteria. The Commission’s report is perhaps a bit more outspoken in its assessment by saying that “signs of overheating have strengthened, particularly against the background of a rapidly tightening labour market.” (European Commission 2006) Agreeing with the ECB’s assessment that the government’s strategy of balanced budgets may not be sufficient to stem the increasing demand pressures, it draws attention to the fact that the cyclically adjusted surplus has been declining in 2005 and 2006 indicating a pro-cyclical fiscal stance in a period of very strong growth. It also claimed that the fiscal stance in 2007 is going to be even more expansionary. The Commission also points out that while foreign exchange risk is mitigated by the currency board arrangement, the share of foreign currency lending is the highest among the EU10, with approximately 80% of outstanding private sector lending denominated in euro. In anticipation of the post-Lehman problems it then states that “whereas the banking sector and corporate borrowers would seem appropriately hedged, the exposure to un-hedged foreign currency borrowing in the household sector is a potential source of vulnerability in the economy”. But the overall tone of the report was still relatively optimistic: “Provided that Estonia remains on a strong growth path supported by a credible macroeconomic policy mix, an orderly deceleration of the external deficit towards more sustainable levels appears the most likely medium-term scenario.”

The year 2007 began very well for the incumbent finance minister; *The Banker* magazine elected him the finance minister of the year in recognition of Estonian strong economy and sensible fiscal policy. The feel-good factor did not last for long though; as the minister’s party was defeated in the March general elections and he had to leave the office. One of the first steps of the new government was to bring the planned EU-demanded excise tax hikes forward into 2008 in order to alleviate the pressure from administered prices in 2009-10. In June, the Bank of Estonia declared that the earliest Estonia can access the euro area is 2011. The postponement led to another round of the revision of ratings as both *Standard & Poor’s* cuts its outlook to negative and *Moody’s* to stable in September 2007. Two months later, the nervousness around currency exchange booths triggered two reassuring statements from the Bank of Estonia on the stability of the exchange rate.

In January 2008 *Fitch* brought its credit rating outlook to negative, but in his speech in the British-Estonian Chamber of Commerce in April the prime minister assessed the overall situation of the economy and the investment climate to be positive. He added, however, that the greatest challenge facing Estonia is to improve the flexibility of the labour market and productivity.

The ECB convergence report that was published a month later in May 2008 showed increasing signs of dissatisfaction with the government’s fiscal policy: “The country’s fiscal stance ... has not been sufficiently tight to counter the growing signs of overheating.” (European Central Bank 2008) More worryingly, the ECB pointed out that for 2008 government foresaw large expenditure increases in the form of higher pensions and family

benefits. The ECB was concerned that a strongly expansionary fiscal stance in 2008 and planned further loosening in 2009-11 might add to domestic demand pressures and work against the improvement of the large current account deficit. While Estonia fulfilled the exchange rate stability criterion – went the report further – increased risk-aversion combined with market concerns about the high external imbalances has in the late 2007 widened the short-term interest rate differentials. It is also the first time that the ECB voices concerns about the long-term interest rate developments. Although it reiterated that there is no harmonised long-term interest rate indicator for Estonia, it also pointed out that the purpose of the interest rate criterion is to determine the durability of convergence and to assess participation in the exchange rate mechanism. It continued then by saying: “In this respect, during the period under review, some concerns among market participants regarding the sustainability of convergence have emerged. This has been reflected in the outlook status of Estonia’s sovereign credit ratings and warning comments from the credit rating agencies.” Overall, irrespectively of the generally vigilant tone, the report stopped short of issuing a negative assessment. The Commission’s report added that the hedging activity of foreign firms with kroon exposure had recently increased – a further sign of increased global risk-aversion and intensifying concerns about macroeconomic imbalances.

The impact of the global crisis

Lehman’s bankruptcy caught Estonian government in midst of a budget crisis that almost led to the dissolution of the ruling coalition, as it became increasingly clear that the expenditure commitments made in the post-election exuberance were not sustainable in the considerably harsher economic environment. Necessary fiscal consolidation was moreover greatly complicated by the budget’s inflexibility: the share of expenditures driven by entitlements and tax earmarks had risen to 70%. As the y-o-y nominal economic growth plunged from positive 16.6% in Q1 2007 to negative 4.7% a year later, the magnitude of the structural deficit caused by the expenditure increases (particularly in wage bill and pensions) became apparent. To their credit, it must be conceded that the authorities promptly responded to a new set of challenges. In November the ministry of finance identified the key short-term goals of its budgetary policy: maintaining a fiscal buffer as long as the credit crisis made borrowing from the international capital markets very difficult and, crucially for our purposes, ensuring that the deficit does not endanger euro adoption by exceeding the 3% of GDP target.

Although the supplementary budget adopted in February addressed the issues created by the sharpest downturn since the beginning of the 1990s, it was probably just the first step on the potentially very strenuous fiscal efforts. The first area of significant cost-cutting was operational expenditure that was reduced by an average of 8% across ministries. The wage bill was initially frozen at the 2008 level and the number of civil service employees reduced. The Reform party agreed to postpone previously agreed income tax cuts and there were minor steps in raising revenue through indirect taxes and charges. To begin with the government hoped to get away with the deficit of 1.9% of GDP, but it soon turned out that lower-than-budget receipts and poor expenditure control by local governments implied much worse fiscal position. Thus, in the last macroeconomic forecast from March 2009 the government envisages a 2.9% deficit for 2009 and a massive 7.5% deficit for 2010.

The implications in terms of the euro area accession are twofold. On the one hand, the government rhetoric has changed considerably and the euro is now seen as a major insurance policy in these times of stress. The prime minister has assembled a high level task force consisting of ministers of finance and economic affairs, leaders of the parliamentary factions of the ruling coalition and the presidents of the Bank of Estonia and the Chamber of Commerce to co-ordinate country’s efforts in this area. It has also firmly

stated that it will attempt to join from 1 January 2011 which means that it will try to meet all the Maastricht criteria already this autumn. However, it is very unlikely that given the projected 7.5% deficit for 2010 the Commission will not raise the sustainability issue if there are no major efforts to balance the books in 2010. Therein lies the rub, if (and once) these cuts to reduce the jumbo-deficit of 2010 start in the earnest, the current relatively strong public support for the euro is likely to dissipate. "We have to decide right now, whether the euro is an attainable goal for us in the first place" – says a former adviser to the prime minister – "for too rigorous expenditure cutting may destabilise the situation. "We may in this belt-tightening of ours to suffocate ourselves altogether and end up without the euro anyway. There are limits out there and politicians have to decide now how to go about them."

As things stand now, the government is actively lobbying Brussels to soften the entry criteria for all applicants. I personally think that this approach is unlikely to succeed so that the government will have to meet the Maastricht criteria to be adopted to the euro area anyway. Right now the authorities are once again putting on a brave face and hope with vigorous cost-cutting to meet the crucial 3% budget deficit target. It is interesting to note that the government approaches the whole exercise from the rather technical point of view: "When it comes to the Maastricht criteria, it's all about statistics anyway," says a high-ranking government official and goes then to reproach the head of the government statistical office "who tries to be holier than Pope" when it comes to the government finance statistics. But it is controversial to say the least, for it could as well be argued that the Maastricht criteria are not just about statistics but about an economy being in a certain shape. If the Commission at the whole problem from this angle, it is very unlikely that our last minute euro bid has much chances for success. "The Estonian economy is like an old Russian bus cruising between Tallinn and Tartu¹³; if it goes at its normal speed, it doesn't get anywhere, and when it speeds up, it'll be fined," explains a local investment banker his view. Given this rather telling metaphor I think that the probability of Estonia meeting the Maastricht criteria over 2009-10 is rather slim indeed. The Commission does not even need to raise the "sustainability" card, by now it is painstakingly clear that the country does not fulfil the long-term interest rate target.

The inability to meet the criteria will have a couple of important consequences. First, the cost of capital for local residents will have to rise, as the postponement of the changeover day is bound to damage the country's credibility in international capital markets. The low initial debt value, on the other hand, implies that the government is not going to have major financing problems. Indeed, it has already secured two loans from European Investment Bank and *Swedbank*. On the other hand, the postponement of the changeover day is also raising questions about the survivability of the currency board arrangement. "Yes, there is much more talk about devaluation in Estonia than there used to be," answers the vice president of the Bank of Estonia to my question whether, in his opinion, the public has recently grown more permissive about the D-word. But "without the fixed exchange rate there would have been no budget cuts," goes he then further, "what other nominal anchor would you have then? Spending, perhaps? It would be particularly silly to give it up in the half-way through the adjustment, unless there is a revolution." The big question is, whether it does necessarily take a revolution for the contemporary mass democracy to gravitate away from the fixed exchange rate.

¹³ The second largest city in Estonia, approximately 200 km from the capital.

Conclusion: Progress, Perspectives, Recommendations

Estonia has certainly been one of the star pupils in the convergence class of 1993-2008. According to the IMF, its GDP per capita increased from 5,734 in 1993 to 20,754 current international dollars, implying the eighth highest convergence speed in the sample of 173 countries. In a European context, Estonian per capita GDP has risen from around 40% in 1998 to 67% of the EU average in 2008. The recorded stellar performance is in our opinion explained by the two crucial factors: the miniscule scale of the economy – with its EUR 16bn GDP the Estonian economy is like a small rubber ball where both positive and negative tendencies tend to be amplified – and the geographical and cultural proximity to one of the wealthiest regions in the world: Northern Europe.

Nordic countries – in particular Finland and Sweden – have since the end of 1980s exported their institutions, technological know-how and, since 2003-04, large amounts of capital to Estonia. While the overall impact of these flows has been certainly positive, the Trans-Baltic channel was at the same time also the primary conduit through which the ailments of the credit boom plagued world economy entered Estonia in 2005-08. Thus, the aggregate capital inflow of EUR 6.3bn that was funnelled into Estonian economy over 2005-07 from Scandinavian financial institutions was undoubtedly the single most important determinant of the economic environment of the boom years. Once Estonia entered the EU in May 2004, the convergence process took became characterised by the two directionally opposite movements of capital (in) and labour (out). The concomitant wage cost pressures, credit fuelled income growth and high expectations of permanent income then gradually set the stage for the events that in the Baltics started to unfold already in H2 2007 but were later given a major impetus by the collapse of the Lehman Brothers in September. Since then the exceptionally propitious tendencies that propelled the economy along its convergence trajectory all the way from the beginning of 1990s – with 1998-99 representing a minor setback – have been thrown into reverse. The real GDP that had increased at the average rate of 8.2% in the last eight years to 2007 plunged by 3.6% in 2008 and by further 15.6% in Q1 2009. A contraction of this magnitude following so closely on the heels of long and vibrant expansion now poses to policy makers major policy challenges whose enormity and urgency are only gradually becoming apparent.

“Estonian economic success has been based on currency board system, conservative fiscal policy and liberal foreign trade,” – this has by and large been the economic policy mantra from the beginning of 1990s. The structural issues of trade policy aside, this leaves us with two macroeconomic pillars: the currency board and fiscal reticence. The currency board arrangement was established in June 1992 as a means of dealing with the inflation that had been running at a four-digit rate. Insofar as it was spectacularly successful in doing so, it became synonymous with the tight money policy – a notion that grew increasingly detached from reality as years went by, but particularly after the accession to the EU. As the aforementioned EUR 6.3bn landed on Estonian shores, the growth rate of broad money (M2) reached 31% in 2005 and 35% in 2006 – hardly a sign of monetary stringency. The same applies to the fiscal policy; although the government ran the average fiscal surplus of 1.8% of GDP in six years to 2007, these were the years when nominal GDP grew at an average rate of 14% per annum. The increasingly self-congratulatory tone reached its apex in the budgets of 2007 and 2008 which boosted the central government revenues almost by 60% – hardly a sign of fiscal prudence. As troubles hit home in September 2008, it dawned on policymakers that what was deemed to be a small surplus is actually a massive structural deficit. This unappealing insight is now gradually trickling through the system and triggering a series of policy adjustments and attitude changes, particularly vis-à-vis the common currency.

"I am not ready to sacrifice high economic growth to bring the inflation down," – these words from the prime minister characterise the prevalent attitudes of the government during the giddy days of growth, when it chose to ignore the growing chorus of critics – particularly from Brussels and Frankfurt – who pointed out that the government's strategy of targeting balanced budget is unlikely to be sufficient to contain the demand pressures in the economy. Now that the public revenues are falling at an unprecedented pace and the incumbent coalition is in these very days involved in strenuous negotiations to bring to pass another negative supplementary budget, the economic policy priorities have understandably shifted once again and euro is now conceived and presented to the public as almost a panacea to almost all economic complaints. Indeed, the painful cuts that are required from the public are put forward as a necessary sacrifice to reach the promised land of the common currency – a 180-degree turn from the position expounded at the beginning of this paragraph.

Although the political will to push through the necessary expenditure reductions to achieve the 3% target budget deficit seems to be genuine, there are high obstacles to be cleared. First there is this age-old argument that mass democracy and irrevocably fixed exchange rate make for strange bedfellows. Once the unemployment whose rate that has already risen by more than 7pp from its all-time low of 4% in Q2 2008 starts to bit in the earnest (as it is expected to do after 1 July when the new labour contract law¹⁴ becomes effective) the public's support for the common currency may easily wane. Moreover, if the electorate realises that entering the euro area at the current exchange rate may doom the economy for long years of stagnation (a sort of East German scenario), there is one more reason for second thoughts to emerge. As far as Brussels and Frankfurt are concerned, it could well be that the present turmoil in which most old rules and practices are either explicitly or implicitly called into question will make European decision-makers more lenient towards new entrants. Hence, it cannot be ruled out that the heroic attempts made by a nation of 1.3m to balance its books will win over the rule-bound hearts of the Commission and Estonia will be invited to join from 2011. But overall we think the chances for this scenario be to fairly slim.

So what policy recommendations can be drawn from this all too human story of hubris and its ultimate undoing? Other than the usual platitudes about the importance of fiscal discipline – true as they are – there is perhaps one thing that we want to emphasise. With the benefit of hindsight it seems us that there was clearly one wrong decision – among many others made in fiscal sphere over 2006-08 – made by the Bank of Estonia. Few people would disagree that the purpose of the fixed exchange rate is to reduce uncertainty. By eliminating (for the time being at least) the volatility of one of the key prices, the fixed exchange rate should thus facilitate welfare enhancing cross-border flows of goods and capital. This is particularly relevant for the country of the size of Estonia where the thinness of the foreign exchange market would make the volatility of the freely floating exchange very vexing indeed. Thus, given the circumstances, the fixed exchange rate is probably the least bad option for the miniscule open economy. However, as with almost all human efforts, it is possible to become overzealous in the pursuit of stability. And this is the blunder that the Bank of Estonia made in our opinion. In trying to present Estonian kroon and German mark (and later euro) as perfect substitutes, the Bank of Estonia employed a variety of gimmicks at various times – in the first half of 1990s it sold costless DEM forwards up to 7 years to commercial banks. Initially there were no limits either, so that commercial banks were effectively offered a one-way arbitrage opportunity. "We're just too dumb to use it," reminisces one long-time FX dealer. As the market participants grew more

¹⁴ It has already almost derailed the sitting coalition as the partners – social democrates against other two – are at loggerheads as to how to allocate the pain of the adjustment in the conditions where Unemployment Insurance Fund is burning money at an ever increasing speed.

sophisticated, the Bank of Estonia initially introduced limits and then stopped the practice altogether in 1995. While this rather unorthodox policy did not have major macroeconomic impacts, the regulation according to which the EUREEK open position is unlimited for banks certainly did (it is still effective). For although banks still voluntarily matched their positions by extending euro loans against euro credit lines from the parents, it was the nonbanking public that eagerly seized the Bank of Estonia's overly reassuring message and built up a massive currency mismatch in their consolidated balance sheet. The banks will, of course, not get off the hook either, for they have effectively swapped foreign exchange risk for credit risk. That said, it is not immediately obvious what the right strategy might have been, after all the Bank of Estonia is institutionally the guardian of the fixed exchange rate and by pursuing its described course of action it was signalling to the public its serious intentions.

To the extent that one of the central themes of this story has been the conceit and over assurance on the part of policymakers, banks and non-bank public, we should perhaps try to keep low profile in our policy prescriptions – it seems to us that there is an optimal amount of uncertainty in any system of human interaction and when policymakers try to squeeze the residual uncertainty out, it enters through the back door. And when it does, it comes usually with revenge.

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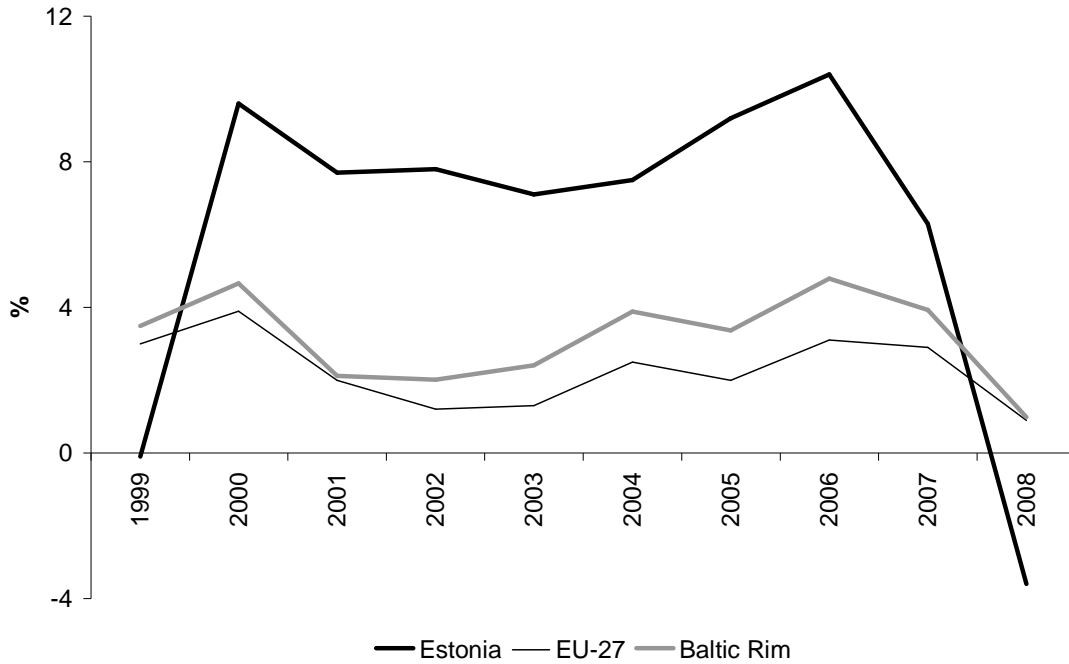
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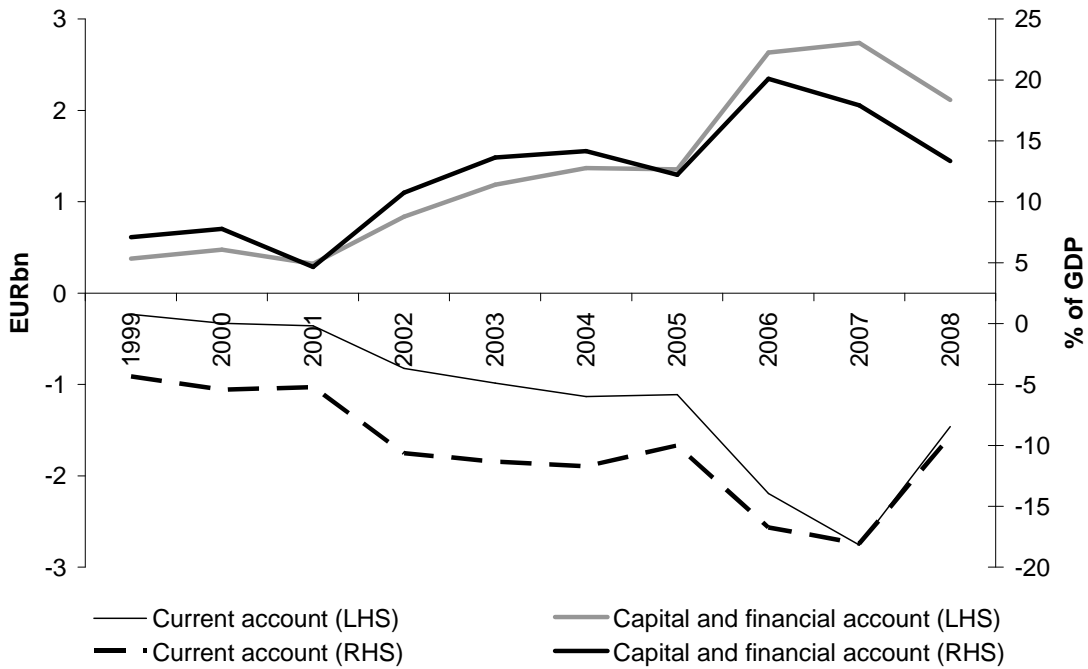
Appendix

Chart 1: Economic growth rates in Estonia, the Baltic Rim and the EU-27



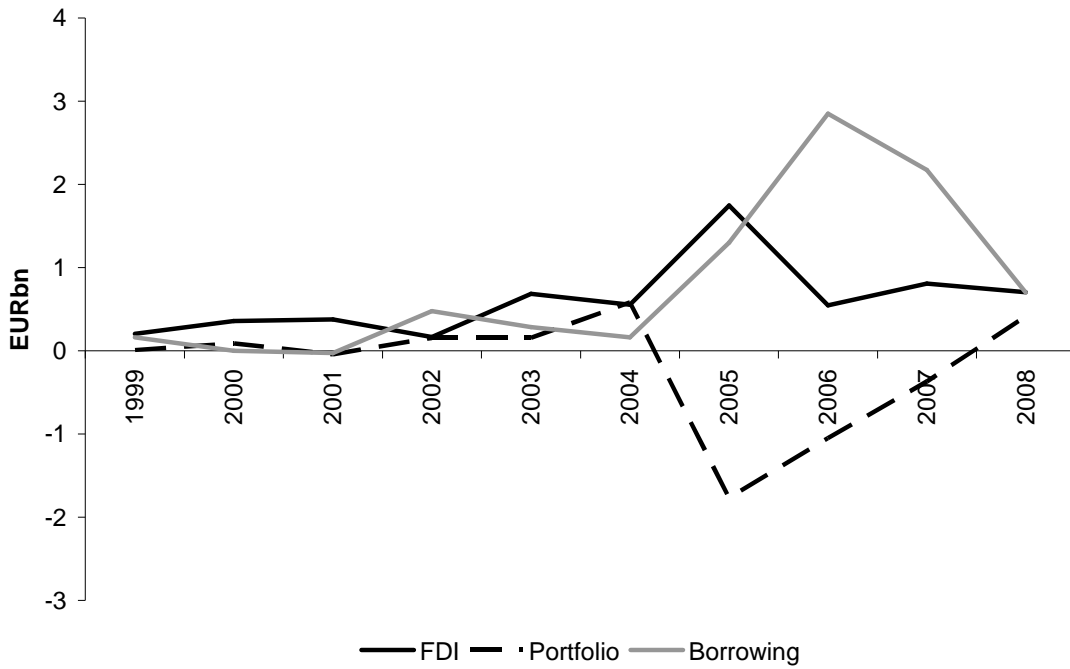
Source: Eurostat, IMF.

Chart 2: Current and financial accounts of the balance of payments



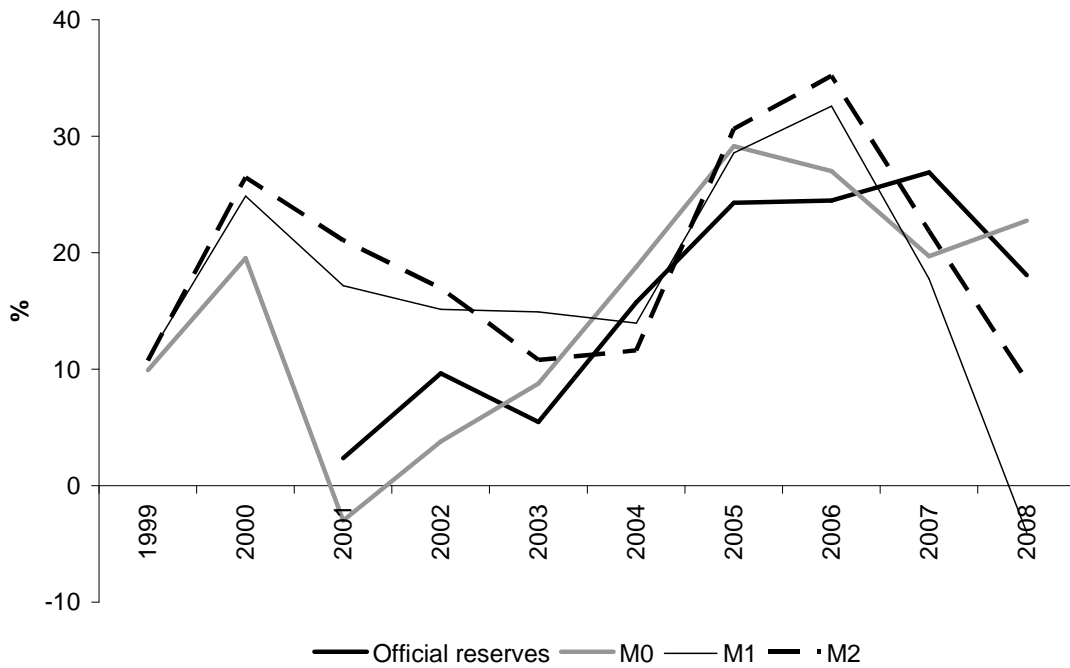
Source: Bank of Estonia

Chart 3: Composition of financial inflows



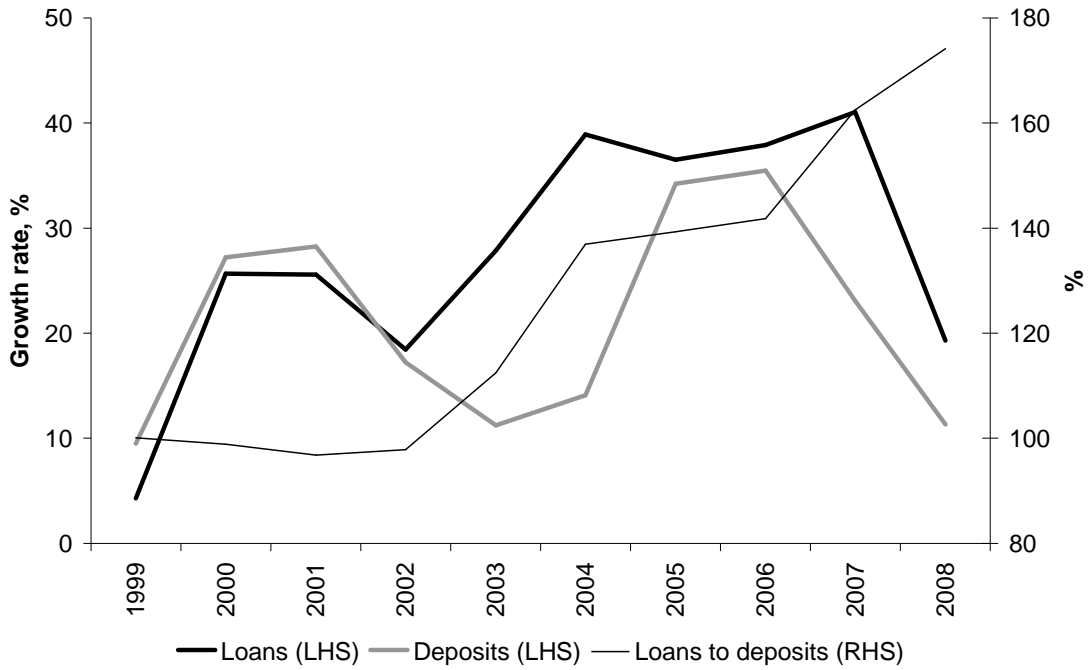
Source: Bank of Estonia

Chart 4: Growth rates of monetary aggregates



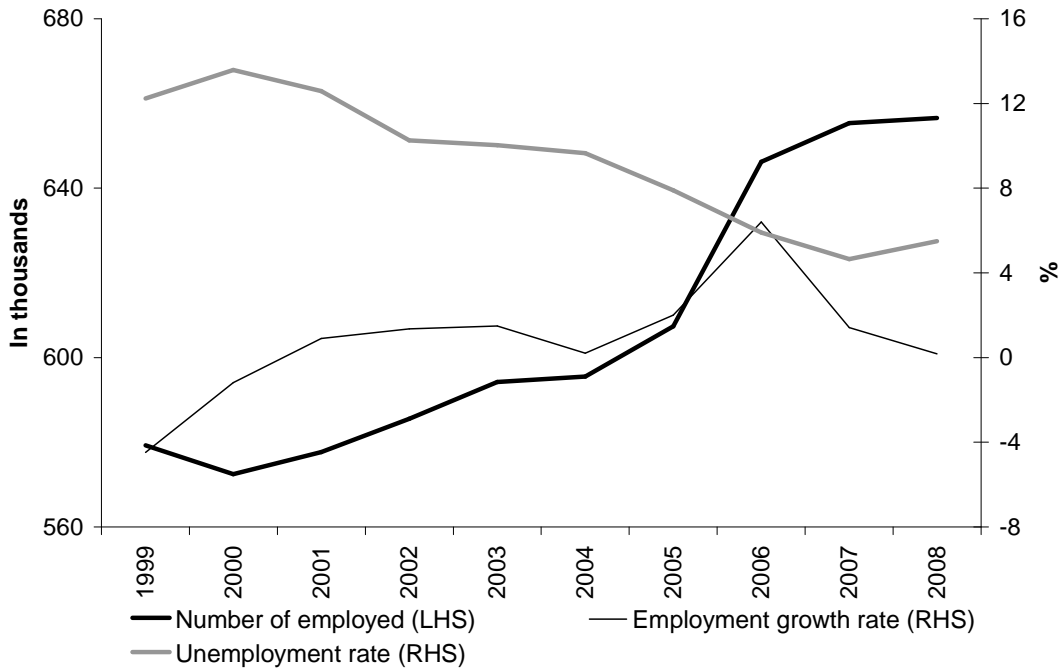
Source: Bank of Estonia

Chart 5: Loan and deposit growth



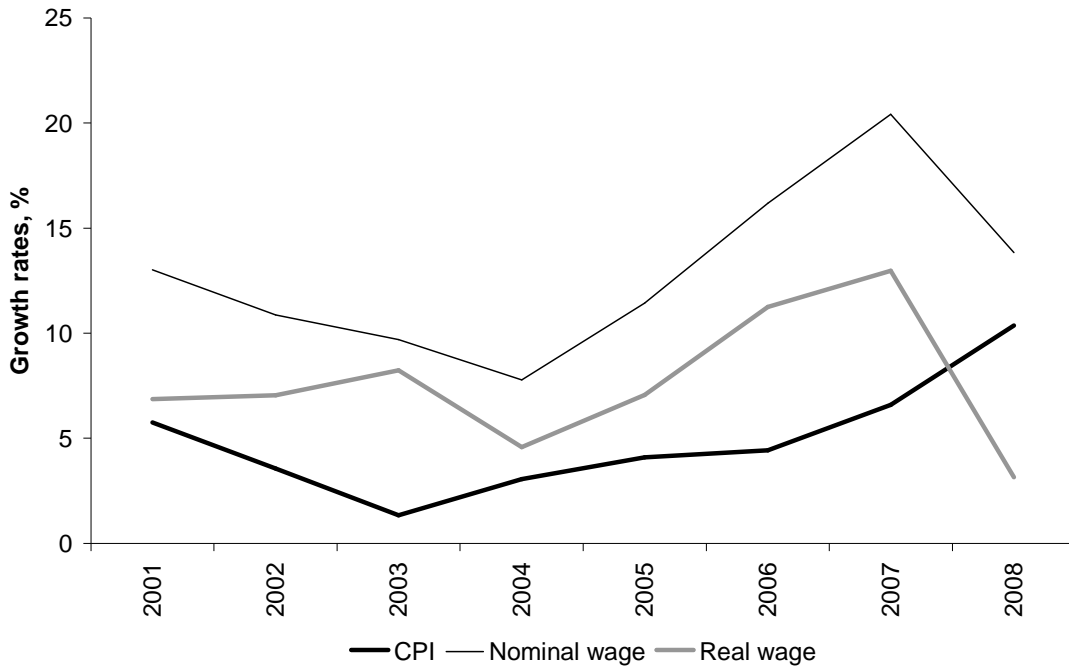
Source: Bank of Estonia

Chart 6: Employment and unemployment



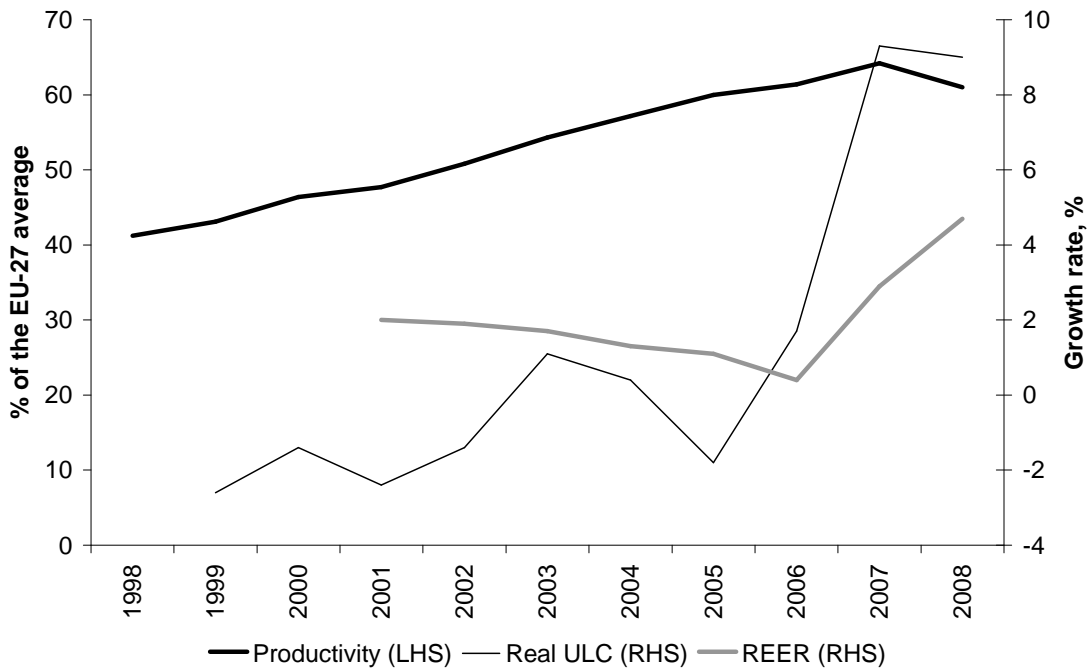
Source: Estonian Statistics

Chart 7: Prices and wages



Source: Estonian Statistics

Chart 8: Productivity, unit labour costs and real exchange rate



Source: Eurostat, Bank of Estonia

Chart 9: Trade performance

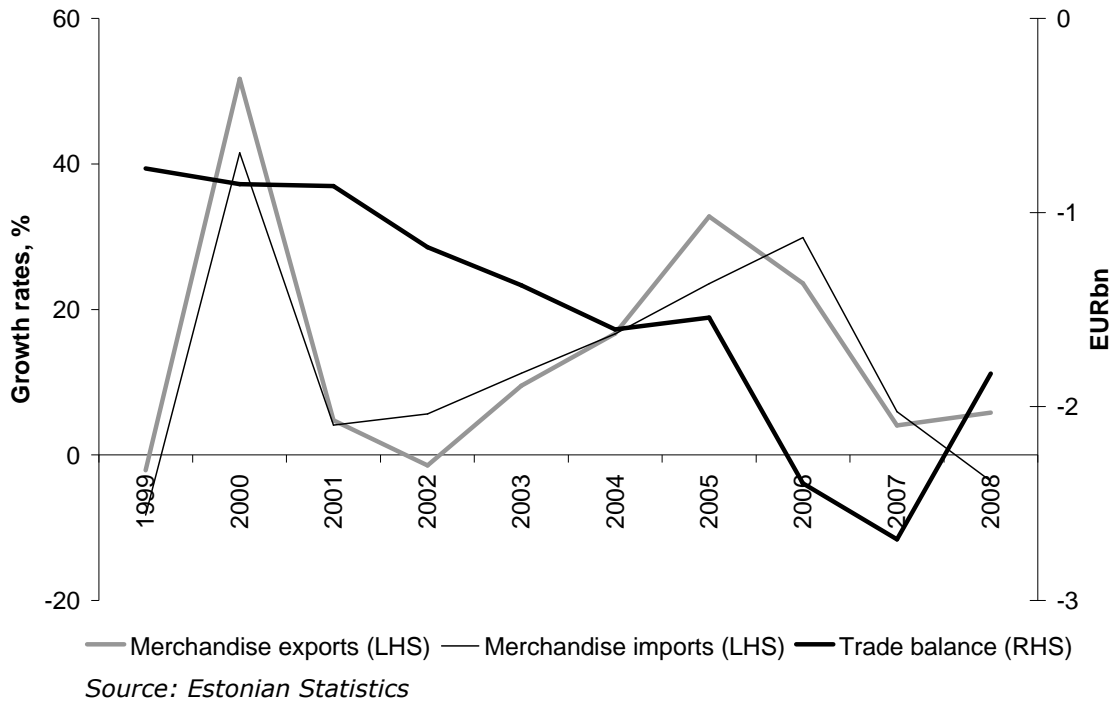


Chart 10: Selected confidence indicators

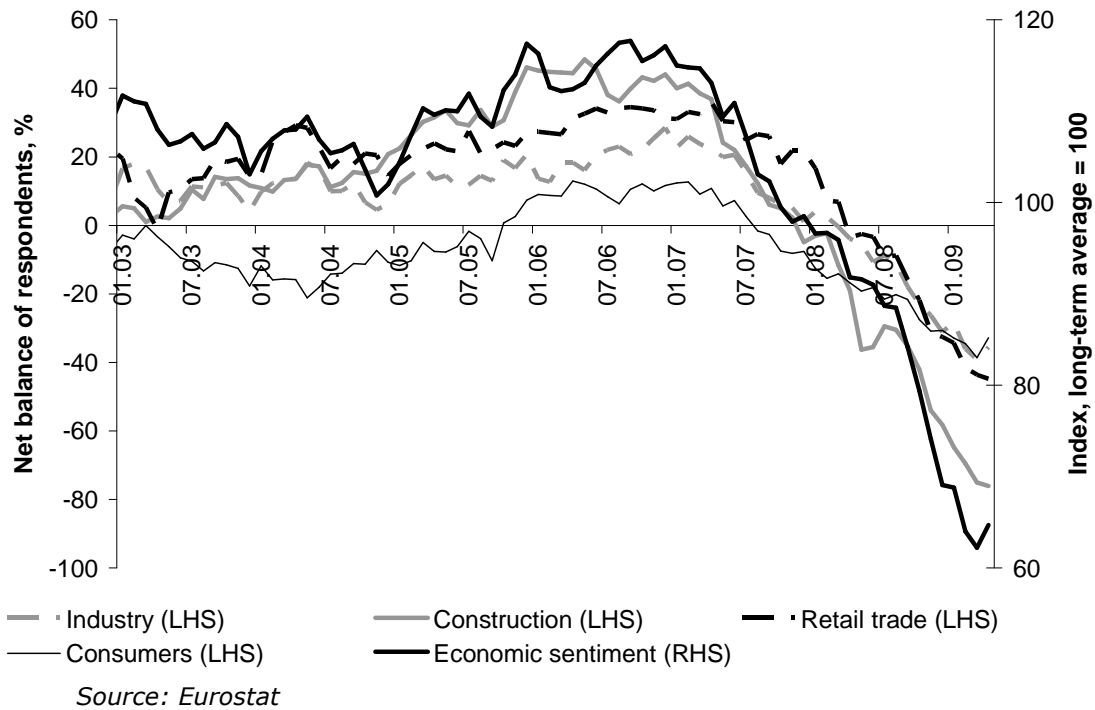
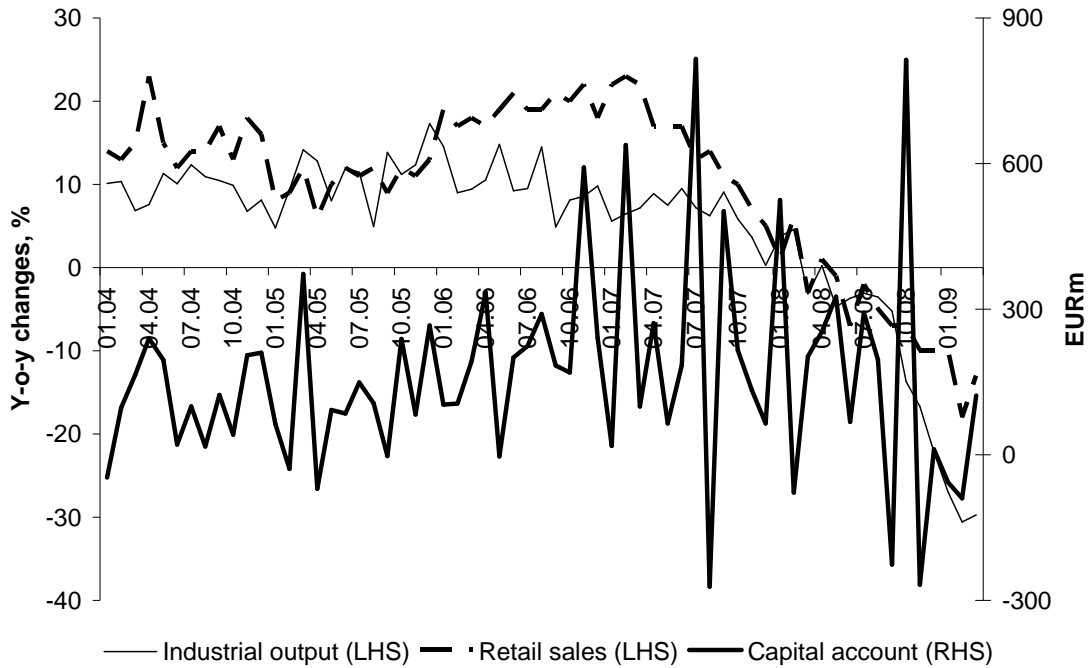
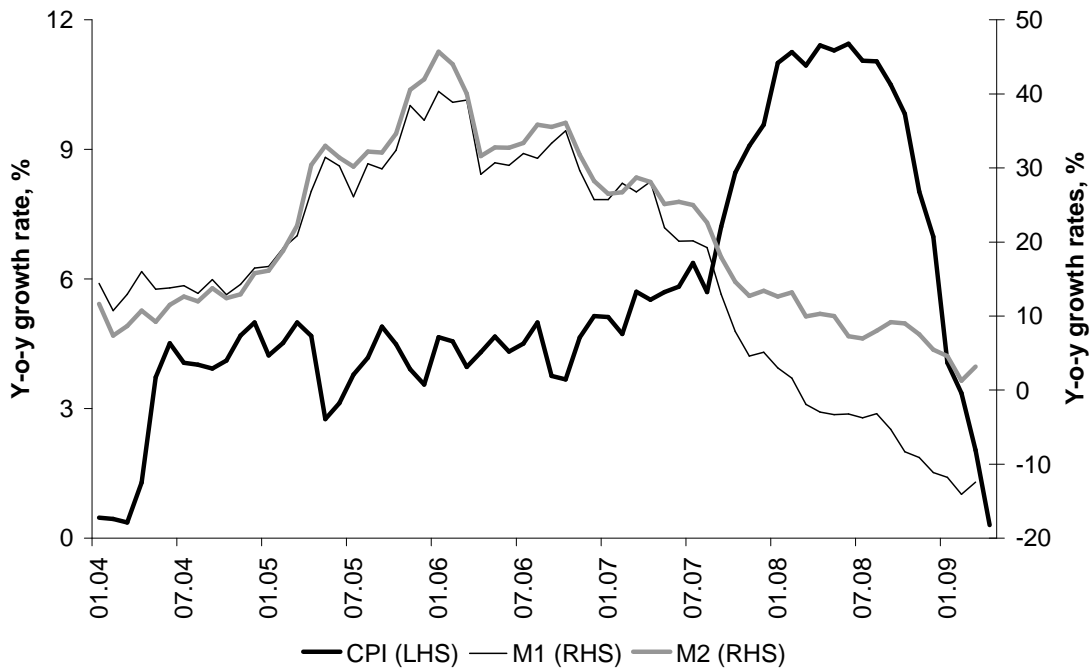


Chart 11: Capital account balance, industrial output and retail sales



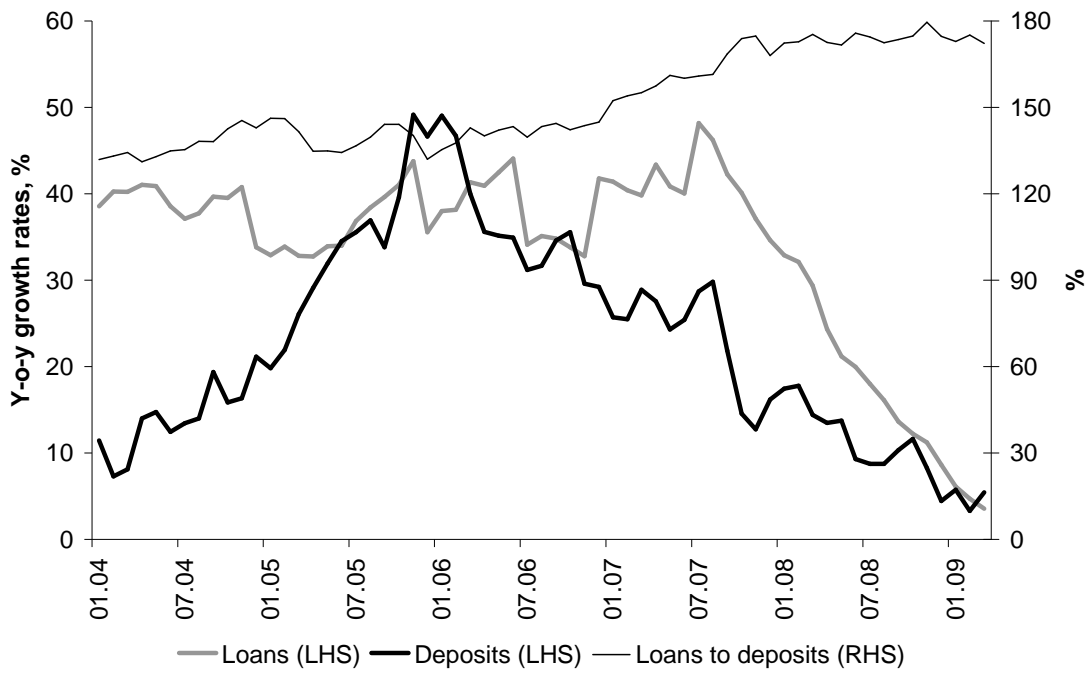
Source: Estonian Statistics, Bank of Estonia

Chart 12: CPI and money growth rates



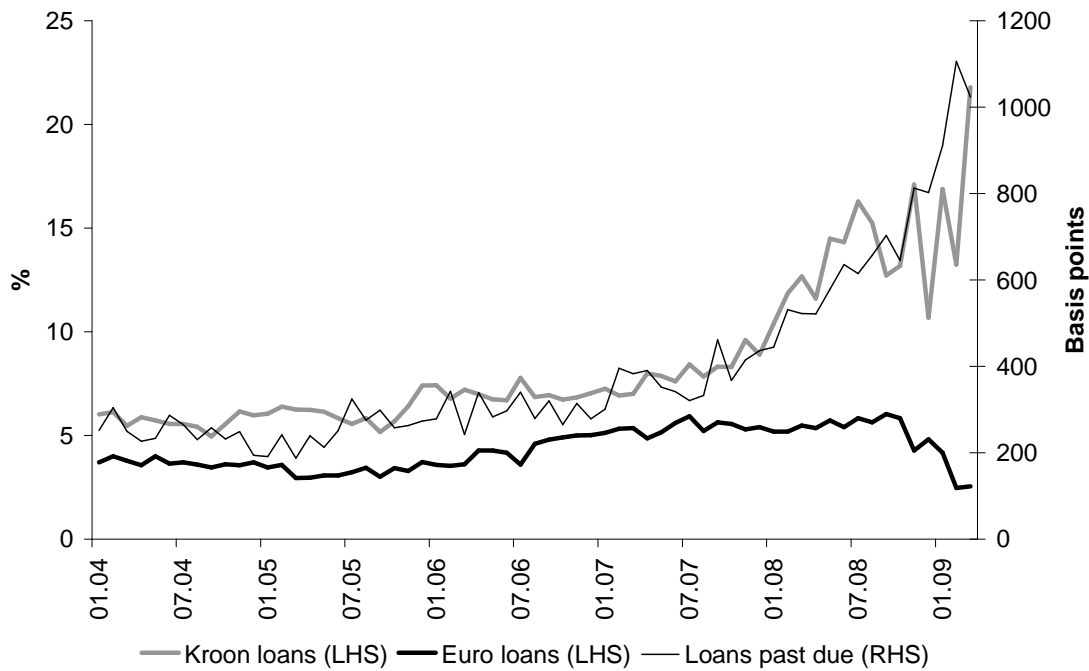
Source: Estonian Statistics, Bank of Estonia

Chart 13: Monthly loan and deposit growth



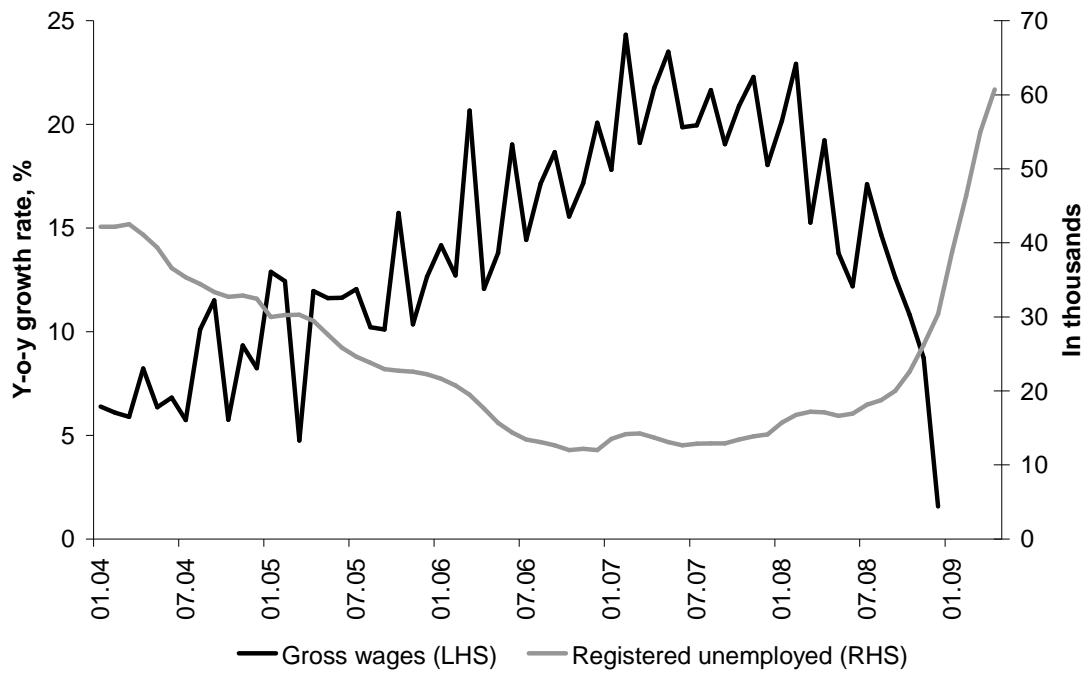
Source: Bank of Estonia

Chart 14: Interest rates and nonperforming loans



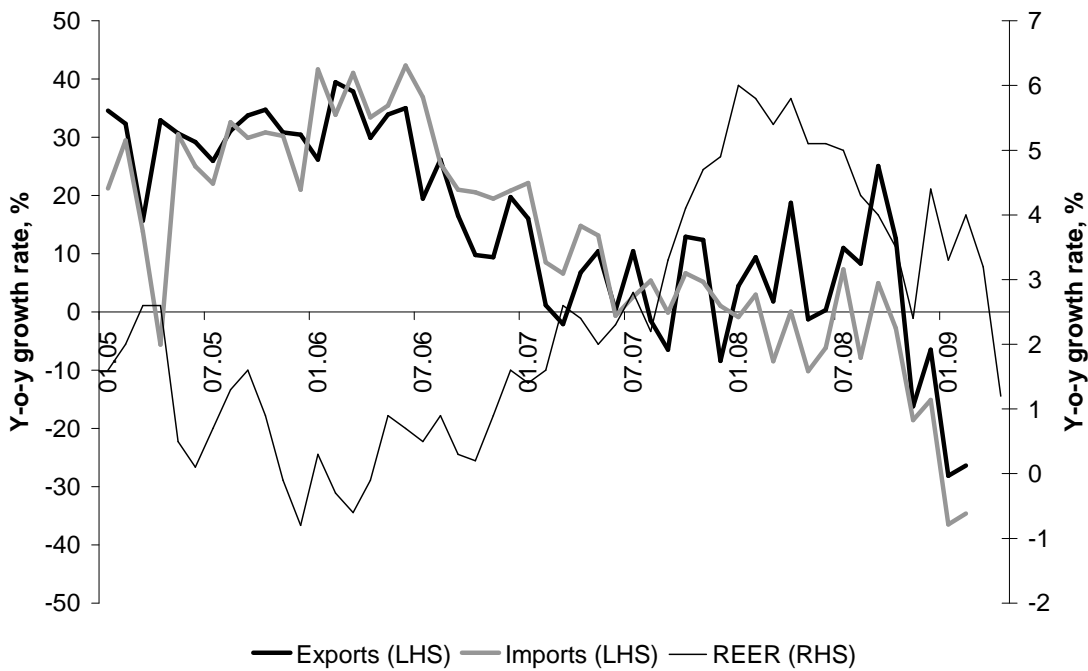
Source: Bank of Estonia

Chart 15: Wage growth and registered unemployed



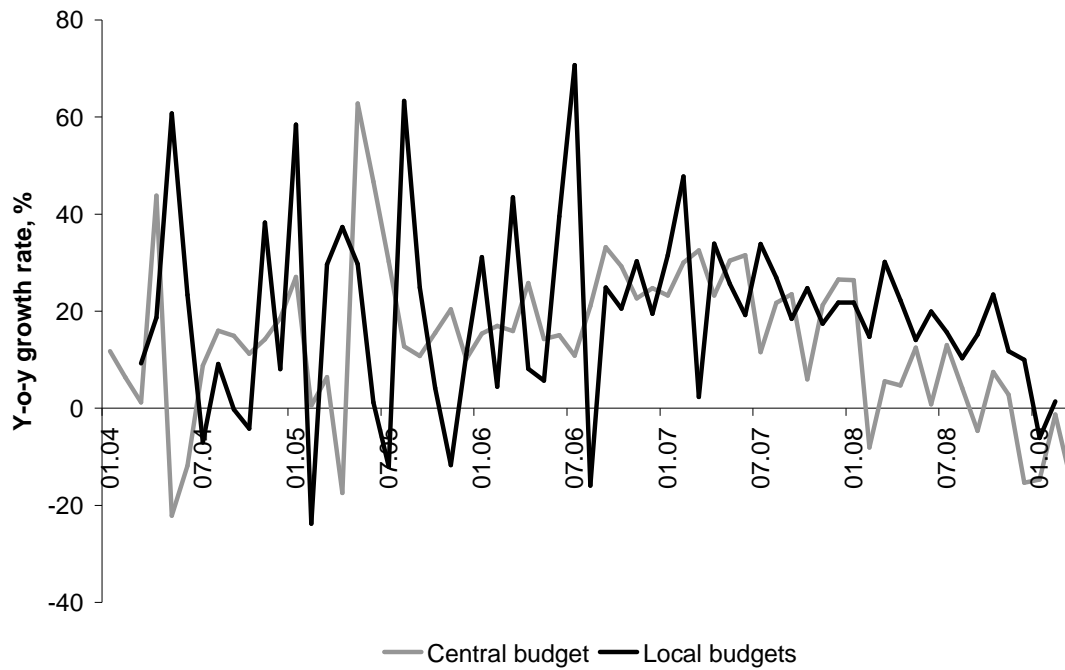
Source: Estonian Statistics

Chart 16: Real effective exchange rate and the growth rates of exports and imports



Source: Estonian Statistics, Bank of Estonia

Chart 17: Taxes to central and local budgets



Source: Estonian Statistics

Table 1: Yearly key economic data

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Inflation; average yearly change of HICP, %	3.1	3.9	5.6	3.6	1.4	3	4.1	4.4	6.7	10.6
Comparative price level; % of EU average	56.9	57.2	61	60.8	62	63	64.7	67.4	71.5	...
Public balance; % of GDP	-3.5	-0.2	-0.1	0.3	1.7	1.7	1.5	2.9	2.7	-3.0
Government debt; % of GDP	6	5.2	4.8	5.7	5.6	5	4.5	4.3	3.5	4.8
Exchange rate; average yearly change against EUR, %	...	0	0	0	0	0	0	0	0	...
Long-term interest rate; end of year, %	...	...	9.2	7.3	4.8	4.3	4.5	5.4	6.8	8.5
Gross external debt; % of GDP	51.5	50.1	52.1	54.4	59.3	69.3	80.2	88.1	101.8	117
Net external debt; % of GDP	8.5	8	6.1	7.5	11.1	15.1	16.9	22.8	31.1	37.6
Exports; yearly change %	-2.1	51.7	4.8	-1.4	9.5	16.7	32.8	23.6	4.1	5.8
Trade with EU-27; % of total	78.5	78	72.8	74.1	72.1	76.5	77.1	70.7	75.1	75.5
Current account balance; % of GDP	-4.3	-5.4	-5.2	-10.6	-11.3	-11.7	-10.0	-16.7	-18.1	-9.2
Gross FDI; % of GDP	3.8	5.9	5.5	2.2	7.9	5.7	15.7	4.2	5.3	4.4
Real GDP; yearly change, %	-0.1	9.6	7.7	7.8	7.1	7.5	9.2	10.4	6.3	-3.6
GDP per capita at PPS; % of EU average	42.3	44.6	46.1	49.8	54.4	57.2	61.1	65.3	67.9	64.2
Employment rate; 15-64, %	61.5	60.4	61	62	62.9	63	64.4	68.1	69.4	
Bank credit; growth rate of average yearly stock, %	4.3	25.7	25.6	18.5	27.9	38.9	36.5	37.9	41.1	19.3
Share of credits denominated in local currency, average yearly %	24.2	22.4	21.3	19.1	18.1	19.7	19.4	21.1	21.6	16.6
Share of credits denominated in euro, average yearly %	3.1	20.3	45.3	76.2	77	74.3	73.6	73.9	75.7	81.4
Share of deposits denominated in local currency, average yearly %	70.4	67.5	67.8	69.3	72.8	72.5	71	67.7	63.4	62.5
Share of deposits denominated in euro, average yearly %	1.7	4	5.9	11.5	11.7	12.5	14	16.8	22.4	26.1
Stock market index; average yearly change, %	-36.2	31.9	-8.3	33.4	39.6	41.4	72.2	11.2	32.2	-40.3
M0; growth rate of average yearly stock, %	9.9	19.5	-3.0	3.8	8.8	18.8	29.1	27	19.7	22.7

M1; growth rate of average yearly stock, %	11	24.9	17.2	15.1	14.9	14	28.6	32.6	17.8	-4.0
M2; growth rate of average yearly stock, %	10.7	26.5	21.1	17	10.8	11.6	30.6	35.2	21.8	9.1
3-month interbank interest rate; yearly average, %	7.8	5.7	5.3	3.9	2.9	2.5	2.4	3.2	4.9	6.7
<i>Sources: Estonian Statistics, The Bank of Estonia, Eurostat, ECB, Tallinn Stock Exchange</i>										

Table 2: Quarterly key economic data

	Q1 2008	Q2 2008	Q3 2008	Q4 2008
Gross external debt; % of rolling year GDP	106.3	109.2	112.2	116.6
Net external debt; % of rolling year GDP	33.1	34.6	35.9	37.6
Government debt; % of rolling year GDP	3.3	3.5	3.7	4.1
Real GDP; y-o-y change, %	0.2	-1.1	-3.5	-9.7
<i>Sources: Estonian Statistics, The Bank of Estonia</i>				

Table 3: Monthly key economic data

	6.08	7.08	8.08	9.08	10.08	11.08	12.08	1.09	2.09	3.09	4.09
Inflation; y-o-y change of HICP, %	11,5	11,2	11,1	10,8	10,1	8,5	7,5	4,7	3,9	2,5	0,9
Exchange rate; y-o-y change against EUR, %	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
3-month interbank interest rate; monthly average, %	6,4	6,4	6,3	6,3	6,7	7,2	7,8	7,3	6,9	7,1	6,5
Long-term interest rate; monthly average, %	8,8	8,2	8,0	8,3	8,5	8,7	8,5	7,6	7,0	9,9	...
Gross FDI; y-o-y change, %	-125,7	-2,5	-17,3	-32,9	-29,4	-37,1	-91,7	-90,8	-68,5	-68,3	...
Current account; 100t/t ₋₁₂	65,1	89,2	18,1	38,4	24,9	56,7	16,2	17,7	15,0	23,2	...
Exports; y-o-y change, %	1,7	11,4	8,2	25,6	13,0	-15,8	-6,1	-28,1	-25,4	-22,8	...
Bank credit; y-o-y change, %	20,0	18,0	16,1	13,7	12,2	11,2	8,6	6,1	4,7	3,6	...
Unemployment rate, %	4,7	5,8	6,4	6,7	6,9	7,4	8,4	9,1	10,0	11,1	...
Industrial production; y-o-y change, %	-3,7	-3,1	-3,5	-5,2	-13,7	-16,7	-22,2	-27,0	-30,6	-29,7	...

Stock market index; y-o-y change, %	-35,3	-44,9	-42,9	-42,1	-54,2	-59,9	-62,6	-56,2	-55,8	-60,0	-55,6
M0; growth rate of average yearly stock, %	34,4	25,4	32,9	7,4	42,3	16,2	28,5	19,9	18,7	13,0	...
M1; growth rate of average yearly stock, %	-3,2	-3,7	-3,2	-5,3	-8,3	-9,1	-11,1	-11,8	-14,1	-12,4	...
M2; growth rate of average yearly stock, %	7,3	7,0	8,0	9,2	9,0	7,5	5,5	4,6	1,3	3,2	...

Sources: Estonian Statistics, The Bank of Estonia, Eurostat, Tallinn Stock Exchange

Yearly data, 1999-2008 (for countries that joined EU in 2004); 2002-2008 (for countries that joined EU in 2007)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
HICP (EU harmonized inflation index)	2.1	2.9	3.7	3.9	3.4	3.0	4.1	4.4	6.7	10.6
Budget deficit/surplus - % of GDP (General Government Budget Balance)	-3.5	-0.2	-0.1	0.3	1.7	1.7	1.5	2.9	2.7	...
General Government Gross debt, % of GDP	6.0	5.2	4.8	5.7	5.6	5.0	4.5	4.3	3.5	...
Long-term interest rates (10-year government bonds) – end of year	...	...	9.2	7.3	4.8	4.3	4.5	5.4	6.8	8.5
Exchange rate - % change against the Euro	...	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	...
Price level compared to the EU average (Eurostat)	56.9	57.2	61.0	60.8	62.0	63.0	64.7	67.4	71.5	...
GDP per capita at PPS as % of EU average (Eurostat)	42.3	44.6	46.1	49.8	54.4	57.2	61.1	65.3	67.9	64.2
GDP growth	-0.1	9.6	7.7	7.8	7.1	7.5	9.2	10.4	6.3	-3.6
Employment rate (15-64)	61.5	60.4	61.0	62.0	62.9	63.0	64.4	68.1	69.4	...
Export growth	-2.1	51.7	4.8	-1.4	9.5	16.7	32.8	23.6	4.1	5.8
Current account - % of GDP	-4.3	-5.4	-5.2	-10.6	-11.3	-11.7	-10.0	-16.7	-18.1	-9.2
FDI - % of GDP (+ % of FDI coming from EU countries, if data exist)	3.8	5.9	5.5	2.2	7.9	5.7	15.7	4.2	5.3	4.4
FDI from EU countries - % of GDP										
External debt (private + public) - % of GDP (+ net external debt, if data exist)	51.5	50.1	52.1	54.4	59.3	69.3	80.2	88.1	101.8	116.6
Trade with EU countries, % of total	78.5	78.0	72.8	74.1	72.1	76.5	77.1	70.7	75.1	75.5
Bank credit growth (% change)	4.3	25.7	25.6	18.5	27.9	38.9	36.5	37.9	41.1	19.3

M2 (% change)	10.7	26.5	21.1	17.0	10.8	11.6	30.6	35.2	21.8	9.1
Interbank interest rates, monthly averages for the corresponding year	7.8	5.7	5.3	3.9	2.9	2.5	2.4	3.2	4.9	6.7
Share of deposits and credits denominated in Euro	24.2	22.4	21.3	19.1	18.1	19.7	19.4	21.1	21.6	16.6
EU banks ownership of local banks, % of total assets	97.8	97.5	97.7	97.6	97.5	98.0	97.5	97.3	97.0	...
Stock market index	110.3	145.4	133.4	178.0	248.5	351.5	605.2	672.7	889.6	531.4
World bank doing business ranking	...	...	...	...	...	...	...	...	...	18.0

Monthly (starting from June 2008) and quarterly (starting from IQ 2008) data. According to the frequency (monthly; quarterly) of their issue

	03/08	06/08	07/08	08/08	09/08	10/08	11/08	12/08	01/09	02/09	03/09	04/09
GDP growth, % change from the same quarter of the previous year	0.2	-1.1	...	...	-3.5	...	...	-9.7	...	...	...	...
Industrial production, % change from the same period of the previous year	...	-3.7	-3.1	-3.5	-5.2	-13.7	-16.7	-22.2	-27.0	-30.6	-29.7	...
Unemployment rate	...	4.7	5.8	6.4	6.7	6.9	7.4	8.4	9.1	10.0	11.1	...
HICP (EU harmonized inflation index), % change from the same month of the previous year	...	11.5	11.2	11.1	10.8	10.1	8.5	7.5	4.7	3.9	2.5	0.9
Exchange rate - % change against the Euro, monthly	...	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Government debt - % of GDP	3.3	3.5	...	...	3.7	...	...	4.1	...	...	...	...
Long-term interest rates (10-year government bonds)	8.8	8.2	8.0	8.3	8.5	8.7	8.5	7.6	7.0	9.9	...	...
Export growth - monthly data compared to the same period of the previous year	...	1.7	11.4	8.2	25.6	13.0	-15.8	-6.1	-28.1	-25.4	-22.8	...
Current account - % of GDP	-13.3	-10.9	...	...	-7.3	...	...	-5.5	...	...	...	...
FDI - % change compared to the same month of the previous year	...	-125.7	-2.5	-17.3	-32.9	-29.4	-37.1	-91.7	-90.8	-68.5	-68.3	...
External debt (government + private) - % of GDP	106.3	109.2	...	...	112.2	...	...	116.6	...	...	...	...

Bank credit growth, % change from the same period of the previous year	...	20.0	18.0	16.1	13.7	12.2	11.2	8.6	6.1	4.7	3.6	...
M2, % change from the same period of the previous year	...	7.3	7.0	8.0	9.2	9.0	7.5	5.5	4.6	1.3	3.2	...
Interbank interest rates	...	6.4	6.4	6.3	6.3	6.7	7.2	7.8	7.3	6.9	7.1	6.5
Stock market index	...	594.1	534.8	528.1	522.5	394.2	312.1	272.9	303.3	291.0	259.2	275.4

	01/07	02/07	03/07	04/07	05/07	06/07	07/07	08/07	09/07	10/07	11/07	12/07
Indicator of country risk premium (monthly since January 2007)*	213.5	160.6	163.9	314.2	270.9	200.8	250.9	262.6	267.2	274.0	429.5	351.5
5-years CDS for Government debt (monthly since January 2007)	...	...	...	...	...	...	...	...	...	...	...	...
	01/08	02/08	03/08	04/08	05/08	06/08	07/08	08/08	09/08	10/08	11/08	12/08
Indicator of country risk premium (monthly since January 2007)*	520.2	667.7	717.2	625.0	876.5	892.1	1045.3	961.0	668.1	734.0	1282.6	586.7
5-years CDS for Government debt (monthly since January 2007)	...	...	...	...	...	...	...	...	...	501.4	504.6	564.1
	01/09	02/09	03/09	04/09								
Indicator of country risk premium (monthly since January 2007)*	1270	1076.3	1924.2									
5-years CDS for Government debt (monthly since January 2007)	546.1	676.0	659.4	495.2								

* The spread between kroon and euro lending rates, in basis points