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IMF Executive Board Concludes 2016 Article IV Consultation with the Republic of Estonia

On January 9, 2017, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with the Republic of Estonia.

Notwithstanding sound economic and institutional fundamentals, including one of the strongest public finances in Europe and a business friendly environment, Estonia's recent growth has been subdued. Labor productivity and external competitiveness have weakened. Growth in 2016 is estimated at only 1.3 percent, driven mainly by private consumption on the back of strong wage growth in a tightening labor market. Exports are gradually recovering, but investment continues to contract. Import growth is accordingly low, keeping the current account in small surplus. Inflation rose moderately to around 1 percent.

The economy should gradually strengthen going forward, as the external environment improves and existing pro-growth policies come to fruition. Growth is projected at 2.3 percent for 2017 and 2.8 percent for 2018, supported by continued robust consumption and higher investment and exports, as well as planned fiscal stimulus in 2018. Inflation should pick up to 2.5 percent in 2017, reflecting rising energy prices, sizable contributions from excise tax hikes, and a moderate pickup in underlying price dynamics. The current account should swing into mild deficit as investment gathers steam and consumption continues to be strong. However, risks to this outlook are mainly to the downside, including failure of external demand to pick up and continued rapid wage growth denting competitiveness.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

Executive Board Assessment[2]

Executive Directors commended Estonia for its strong institutions and determined reforms, which have delivered solid growth and substantial gains in living standards over the past two decades. Despite a more disappointing recent growth performance, Directors concurred that the outlook is for a pick-up in growth, as the external environment improves and existing pro-growth policies come to fruition. Nevertheless, they cautioned that downside risks dominate and challenges lie ahead. In particular, Directors noted that rapid wage growth in tandem with stagnant productivity have started to reduce competitiveness. Against this background, they underscored the need for structural reforms that improve productivity, supported by prudent fiscal policies, and measures to mitigate financial sector risks.

To address these challenges, Directors recommended enhancing productivity and preserving competitiveness through a three-pronged approach that focuses on (i) improving the effectiveness, scale, and take-up of existing pro-growth programs, including by establishing a dedicated productivity unit; (ii) re-anchoring wage growth in fundamentals, including by ensuring that increases in public wages and minimum wages do not front-run private-sector wage growth, as well as by promoting greater female labor force participation and further streamlining government employment to boost labor supply; and (iii) enhancing competitiveness through tax reforms.

Directors agreed that Estonia's strong public finances provide room to support the strengthening of the supply side of the economy under the above-recommended three-pronged approach, while preserving strong fiscal institutions. They also supported the planned further increase in public investment, while stressing the need to ensure high rates of return for both new and existing projects. Directors welcomed the government's steps to tackle income inequality, and took note of the authorities' intention to reform the income tax system to help achieve distributional objectives.

Directors concurred that the financial sector is in a strong position and adequately supports the economy. They cautioned against spillover risks from potential vulnerabilities in Nordic parent banks, and recommended further mitigating these risks by strengthening cooperation with home-country and European authorities in a revamped Nordic-Baltic Stability Group.

[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Republic of Estonia: Selected Macroeconomic and Social Indicators, 2013–18

	2013	2014	2015	2016	2017	2018
					Projections	
National income, prices, and wages						
GDP (billions of Euro)	18.9	19.8	20.3	20.8	21.8	22.9
Real GDP growth (year-on-year in percent)	1.4	2.8	1.4	1.3	2.3	2.8
Private consumption	3.7	3.2	4.6	3.8	2.6	2.8
Gross fixed capital formation	-2.9	-8.1	-3.4	-0.9	4.6	5.3
Exports of goods and services	2.3	3.0	-0.6	4.1	5.2	5.3
Imports of goods and services	3.3	2.2	-1.4	5.7	5.7	5.6
Average HICP (year-on-year change in percent)	3.2	0.5	0.1	0.9	2.5	2.4
GDP deflator (year-on-year change in percent)	3.9	1.7	1.0	1.6	2.1	2.2
Average monthly wage (year-on-year growth in percent)	7.8	5.6	5.9	6.5	5.5	5.0
Unemployment rate (ILO definition, percent, pa)	8.6	7.4	6.1	6.5	7.6	8.3
Unemployment rate, excluding work capacity reform (pa)	…	…	…	5.9	5.8	5.7
Average nominal ULC (year-on-year growth in percent)	6.8	3.6	6.7	6.5	4.8	3.3
General government (ESA10 basis; percent of GDP)						
Revenue	38.4	39.1	40.5	41.4	42.2	42.2
Expenditure	38.5	38.5	40.3	40.7	41.9	42.5
Financial surplus (+) / deficit (-)	-0.2	0.7	0.1	0.8	0.3	-0.2
Structural balance	0.9	1.1	0.9	1.5	0.9	0.0
Total general government debt	10.2	10.7	10.0	9.7	9.3	9.1
External sector (percent of GDP)						
Trade balance	-4.8	-5.1	-4.3	-4.6	-5.4	-6.3
Service balance	7.0	8.5	8.4	8.2	8.0	8.0
Income balance	-2.4	-2.5	-2.1	-2.5	-2.6	-2.6
Current account	-0.1	1.0	2.2	1.2	0.2	-0.7
Gross external debt/GDP (percent) 1/	92.4	96.7	94.8	89.5	83.1	76.8
Net external debt/GDP (percent) 2/	-5.4	-10.2	-10.3	…	…	…
General government external debt/GDP (percent)						
Excluding government assets held abroad	10.2	10.7	10.0	9.7	9.3	9.1
Including government assets held abroad 3/	-1.5	-1.3	-1.7	-1.6	-1.6	-1.2
Exchange rate (US$/Euro - period averages)	1.3	0.0	1.1	…	…	…
Real effective exchange rate (annual changes in percent)	2.7	0.1	-1.9	…	…	…
Nominal effective exchange rate (annual changes in percent)	1.6	1.6	-1.0	…	…	…
Money and credit (year-on-year growth in percent)						
Credit to the economy 4/	1.1	3.3	4.8	6.2	…	…
Output gap (in percent of potential output)	-2.4	-0.8	-0.9	-1.4	-0.7	-0.3
Growth rate of potential output (in percent)	1.8	1.2	1.5	1.7	1.7	2.4

Social Indicators (reference year):

Population (2014, pa): 1.32 million; Per capita GDP (2014): $20,126; Life expectancy at birth (2013): 81.1 (female) and 71.2 (male);

Poverty rate (share of the population below the established risk-of-poverty line, 2013): 21.7 percent; Main exports: machinery and appliances.

Sources: Estonian authorities; Eurostat; and IMF staff estimates and projections.
1/ Includes trade credits.
2/ Net of portfolio assets (including money market instruments, financial derivative assets, other investment assets, and reserve assets held by Estonian residents.
3/ Includes the Stabilization Reserve Fund (SRF).
4/ Loans and leases to households and non-financial corporations. For 2016, based on data at end-September 2016.