Statement by Thomas Ostros, Executive Director for the Republic of Estonia and Eve Anni, Alternate Executive Director
January 9, 2017

On behalf of the Estonian authorities, we would like to thank staff for the comprehensive and constructive policy discussions in Tallinn during the Article IV consultations as well as for the insightful set of reports. The authorities broadly agree with staff's assessment and appreciate the policy recommendations.

Recent macroeconomic developments and outlook

Estonia's real GDP growth remains around 1 percent in 2016 after having lost the momentum in recent years. Robust private consumption, supported by rapidly rising real wages, has been the main driver of growth, while weak external demand and uncertainty about trade prospects have been a drag on exports and investment. The primary dampeners on economic growth in 2016 were oil shale and energy sectors that suffered from the low oil price. However, recent data indicates a turning point with manufacturing growth picking up as the oil shale sector's negative effect dissipates and exports recover.

Going forward, economic growth is forecast to gather pace as exports and investment strengthen. In particular, public sector investment is expected to contribute significantly as the EU structural funds under the new allocation period are absorbed. Domestic demand, being supported partly by favorable monetary environment, will remain the main driver of growth, however, external demand and corporate investment will strengthen gradually and exports will play a more important role.

The authorities share the view that a sustained acceleration in growth requires a solid pick up in productivity. Productivity gains are considered critical in order to avoid growth falling behind the projected trajectory, particularly given that the growth contribution of increased employment becomes exhausted. While there is some room to increase labor productivity through lifting average hours worked, the decline in corporate investments in recent years has probably reduced growth potential for the economy. The authorities concur with the staff assessment that it is essential to increase productive investments. Estonia's recently appointed new government envisages further simplifications of business regulation for SMEs, reductions in corporate tax rates for intercompany dividends in order to stimulate investments, and improvements in the regulative and tax environment for high growth potential sectors in order to enhance competitiveness. The government has renewed the commitment to achieve the 1 percent of GDP level of public R&D expenditures and seeks to further encourage the business start-up rate. The authorities also agree with staff that strengthening the oversight of government programs for enhancing competitiveness is beneficial for ensuring their effective implementation. Staff's advice on setting up a separate productivity unit within the Prime Minister's Office, following examples of best practices from around the world, is already being considered.

©International Monetary Fund. Not for Redistribution

The authorities agree that risks to the growth outlook are skewed to the downside. Estonia's small and very open economy is particularly vulnerable to the external environment, including political risks in Europe, and weaker economic prospects for its main trading partners could further delay a rebound in growth. Domestically, it is primarily the labor market developments that could dampen prospects for productivity growth and erode competitiveness and the authorities will monitor labor market developments particularly closely.

Labor market developments

The labor market participation rate in Estonia has reached historically high levels, partly as a result of higher wages, which have motivated more active labor market participation of the working age population. Additionally, measures like raising the official retirement age and more specifically, the phasing in of the Work Ability Reform aimed at reviewing the assessment of capacity to work within the disability pension system, should unlock resources for lower paid sectors. After a long lasting decline, 2016 was the first year when the population of Estonia increased. Nevertheless, total employment is likely to shrink due to demographics, keeping the labor market tight and a continuous upward pressure on wages.

The rapid wage increase, which has been consistently above productivity growth in recent years, is a concern and the authorities agree that the divergence between labor costs and productivity developments is unsustainable. Although the latest data indicates moderation in the growth of labor costs, the associated risks to competitiveness persist. While wage negotiations in Estonia are outside the authorities' direct control, the government acknowledges that public sector should not front-run general wage dynamics and future developments in this area will be closely monitored.

Fiscal policy

Estonia's fiscal rules and actual outcomes have been fully compliant with the requirements of the EU's Stability and Growth Pact. Estonia's gross public debt is currently at around 10 percent of GDP and net debt is close to zero due to sizable liquid reserves. The budget has been in surplus from 2014 onwards. In 2016, the nominal budgetary position of the general government will reach a surplus of 0.3 percent of GDP as revenues exceeded expectations while the execution rate of investments was lower than anticipated.

The new coalition government will introduce changes to fiscal and tax policies but has confirmed a commitment to preserving a sound and sustainable fiscal policy while maintaining a structurally balanced budget in the medium term. The fiscal rule will be made more symmetric by allowing structural surpluses of previous years to be followed by structural deficits, which cannot exceed 0.5 percent of GDP. To promote long-term economic growth, the government foresees stepping up public investments into infrastructure and information technology. The government envisages fully or partly privatizing a number of state owned enterprises. A significant change will be introduced to the personal income tax system by lowering the tax wedge for lower and middle income earners. The corporate income tax rate on regular dividend payments will be reduced to 14 percent and adjustments

©International Monetary Fund. Not for Redistribution

are going to be made to the excise tax system. The cuts to social security contributions planned by the previous government are not going to be implemented. However, labor tax alleviations or tax credits for rapidly growing and start-up companies together with the indirect effect of raising the tax free personal income are assumed to work for the same purpose.

The authorities agree that fiscal policy should be geared towards improving competitiveness. However, in the environment of already robust wage growth and a historically high employment rate, public investments should be scaled up only when there are clear supply side benefits and positive returns for the entire economy without causing labor market distortions.

Financial stability

Estonia's financial sector is sound and stable, with well capitalized, liquid, and profitable banks, whose asset quality is high and non-performing loan ratios low. Risks to the financial sector are reduced by the financial buffers of non-financial corporates, the relatively good finances of the households and the high level of capitalization in the banking sector. Credit demand has been relatively strong, while the ability of corporates and households to service their loans has remained good due to previous buildup of financial buffers and the low interest rate environment.

The dominant Nordic cross-border banks (over 90 percent of the banks operating in Estonia are part of the large Nordic banking groups) imply mainly external financial risks that are mitigated by sizable capital buffers of the banks. Domestic risks relate mostly to potential spillovers from the housing market but these risks are not acute as mortgage lending growth remains moderate.

Various macro-prudential measures have been introduced in recent years to increase the resilience of the financial system and to reduce systemic risks. Since August 2016, a systemic risk buffer requirement of 1 percent applies to all banks in Estonia with additional capital buffers of 2 percent required for the two systemically important credit institutions. The counter-cyclical capital buffer requirement was introduced in 2016 and its level is adjusted according to quarterly assessments of changes in the credit cycle.

Close cooperation with Nordic banks' home-country authorities is essential and mutual efforts will continue to revitalize the Nordic Baltic Financial Stability Group. A few weeks ago the Nordic and Baltic central banks signed an agreement on the principles for sharing information and providing emergency liquidity assistance with regard to cross-border banking groups. The new agreement, which replaces the one agreed in 2003, will further improve financial stability in the region.

©International Monetary Fund. Not for Redistribution