



## Republic of Estonia: Staff Concluding Statement of the 2022 Article IV Mission

FOR IMMEDIATE RELEASE

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under [Article IV](#) of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

**Tallinn, Estonia – May 18, 2022:** *The fallout from the war in Ukraine has made the outlook more uncertain and has stoked inflation. Growth is expected to slow to around 1¼ percent this year, versus 8¼ percent in 2021, and then to recover gradually. Inflation is projected to remain well in double digits this year, significantly ease next year, and broadly normalize in 2024. Risks are mostly dominated by adverse spillovers from the war. In this uncertain context, policies should remain agile in order to respond to changing conditions. Fiscal space should be efficiently used to tackle the evolving refugee, security, and energy challenges, while leveraging EU funds for advancing the green-digital transitions. Energy subsidies should be well-targeted to low-income households. In parallel, investments in alternative natural gas supply and renewables should be scaled up to enhance energy security. Active labor market policies should be further expanded to reduce skills gaps and leveraged to integrate refugees from the war in Ukraine. Supervisory policies should be tailored to contain financial stability risks emerging from the war, while progress on AML/CFT reform framework and agenda, including to limit risks from the fintech sector, should continue. Continual contingency planning is an essential policy priority.*

### Economic Situation and Outlook

**The strong recovery from the COVID-19 shock is slowed by the war in Ukraine and the upsurge in inflation.** Economic activity has been resilient to COVID-19 and the health system has progressively adapted to the pandemic, despite the high caseload from the recent Omicron wave. However, the economy is vulnerable to fallout from the war in Ukraine and the related sanctions. Although direct exposures to Russia and Ukraine through trade, services, and financial channels appear to be contained, there could be larger potential terms of trade shocks. Output rebounded sharply last year (by 8¼ percent), buoyed by large policy support, pension savings withdrawals, and strong foreign investment. High-frequency indicators suggest waning economic confidence in recent months, but retail sales have grown strongly. In parallel, inflation has surged (to 19 percent in April), reflecting high imported energy and food prices, growing domestic demand, spillover effects on other prices, and supply chain

disruptions, with the war exacerbating some of these effects. One-off effects from the expiration of energy price support measures have contributed to the monthly inflation jump in April. The labor market has lagged the output recovery, but labor shortages have emerged and nominal wage growth has accelerated.

**Economic growth is expected to slow this year and recover in the medium term, but downside risks are high.** Growth is expected to weaken to 1¼ percent at end 2022, owing to trade disruptions, a drag from higher energy prices, lower confidence, and lingering supply bottlenecks. Growth is projected at 2.2 percent in 2023, and over the medium term it would gradually recover to its potential clip of around 3¼ percent. The inflow of refugees from Ukraine is expected to slightly mitigate labor shortages. Inflation is expected to start easing in the second half of this year, but is projected to remain well in double digits (16 percent) on average this year, before falling markedly from 2023. The balance of risks to growth is tilted to the downside, primarily due to ongoing uncertainty and spillovers from the war. The external risks include potentially higher energy prices, disruptions in energy supply, less orderly migrant flows, possible cyberattacks, and potential spillovers from trading partners and sanctions as well as from a normalization of monetary policy and yet-tighter global financial conditions. The possibility of new virulent COVID-19 strains represents another risk to growth. Persistent supply shortages combined with upside surprises in domestic demand, and the associated entrenching of elevated inflation could create risks of a wage-price spiral and start to erode competitiveness. On the upside, good implementation of the Resilience and Recovery Plan (RRP) would support growth.

### ***Re-orienting Fiscal Policy***

**The 2022 fiscal stance is appropriate, but new fiscal risks are emerging.** Policy space remains significant, owing to low debt, the expiration of most COVID-19 measures, EU grant funding, and still accommodative financial conditions. In the short term, fiscal space should be efficiently used to address essential spending needs created by the war in Ukraine. As COVID-19 effects diminish, fiscal policy has appropriately pivoted toward broader inclusive growth issues, as well as to new energy security, and refugee-related issues emanating from the war in Ukraine. Defense spending has also increased. The supplementary budget (2½ percent of GDP additional deficit) envisions a more supportive fiscal stance (with an overall deficit of 5.3 percent of GDP), which covers the unexpected costs related to strengthening national security, integrating Ukrainian refugees, and securing energy and natural gas supplies. While earlier measures to mitigate energy price increases through April 2022 have been helpful in times of severe price hikes, such support should be increasingly targeted to low-income households, while the price system should remain flexible. The mission supports the authorities' efforts to assess emerging fiscal risks, in particular those related to cost overruns of investment projects. Carefully designed contingency plans, including in the event of a shut-off of natural gas imports from Russia, could help inform near-term fiscal policy priorities.

**Over the medium term, policies need to further strengthen social safety nets and public investment while accommodating remaining spending priorities.** As energy and refugee-related costs ease, current expenditures would gradually decline as a share of GDP but should increasingly accommodate transformative structural reforms. Investments in energy supply should continue to be prioritized. The timely and efficient implementation of the Recovery and Resilience Plan (RRP) would help boost Estonia's green transition, digital advantage, and social resilience. In this context, fully reaping the growth benefits from

investments and improving absorptive capacity would require advancing planned management and institutional reforms. In particular, heightened uncertainty puts a premium on further fiscal transparency and project planning and management improvements.

**Plans to rebuild fiscal buffers should internalize the changing public spending priorities, while enhancing fiscal policy countercyclicality.** Estonia should continue to expand public investment in the green-digital transition, in line with the European Commission's Spring guidelines for low-debt member states. The forthcoming reform of the EU fiscal pact would provide further guidance on fiscal policies. Notwithstanding, Estonia would benefit from enhancing its automatic stabilizers, which are comparatively low, by following through on the ongoing reform of unemployment benefits that would expand them in bad economic times in exchange for reducing the benefits during economic upturns. The tax policy could be rebalanced to broaden gradually the tax base.

### ***Re-invigorating Structural Reforms and Inclusive Growth***

**Active labor market policies should be further enhanced to ease labor shortages, boost skills, and integrate refugees.** The labor market has significantly recovered from the pandemic, but new challenges have emerged, including due to the war in Ukraine. Labor shortages are a significant challenge, especially in skill-intensive sectors such as ICT and healthcare. Skill mismatches are a key obstacle to further employment growth, and well-tailored training could foster efficient absorption of workers and their reallocation across sectors. In particular, there is scope for increasing training programs for young workers and those with lower qualifications, whose jobs have been particularly affected by the pandemic. In the meantime, a smooth integration of the Ukrainian refugees could ease labor shortages in certain sectors, but this will require stepped-up targeted skill and language training. Going forward, in line with the Estonia 2035 strategy, policies should facilitate development of skills needed for the green transition and the digital revolution.

**Policies to reduce inequality and gender gaps have been progressing, but new social challenges are emerging.** The pandemic-related large policy support and progress on structural reforms have kept inequality on a declining path. The social situation will however be challenged by higher inflation and energy costs, as well as the difficult social conditions of the incoming refugees. The recent increase in the basic subsistence allowance will help support the most vulnerable households. However, the still-elevated old-age poverty rate could be exacerbated by the evolution of inflation and should be monitored carefully. Estonia should build on recent tangible progress in reducing its gender pay gap. The enhancements to parental leave and benefits will favor a more equitable care-load, while nudging programs may help reduce gender gaps in education and the labor market. Ongoing reforms to enhance transparency of pay ahead of the planned adoption of the EU's Pay Transparency Directive are welcome.

**The digital and green transitions should be accelerated.** Estonia has an already vast digitalization agenda aimed at upgrading cybersecurity capabilities and broadband corridors, as well as reinforcing data governance and core IT services. The RRP would provide needed resources, investment support, and digital skills training to address remaining gaps, such as digital capacity in SMEs and rural connectivity. Estonia's European Green Deal commitment to climate neutrality by 2050 hinges on the restructuring of the domestic oil shale sector, which will be critically supported by the EU Just Transition Fund. These commitments should be harmonized with the new priority of cutting dependence on imported energy from Russia,

which entails accelerating investments in green energy generation, gas reserve build-up, and alternative energy supply infrastructure. Further promoting energy efficiency in the building and transport sectors through specific and quantifiable measures, would also help reduce GHG emissions. However, a comprehensive and predictable carbon pricing strategy remains critical to achieve the emissions targets.

### ***Securing Financial Stability and Integrity***

**The financial sector has continued to be resilient but enhanced vigilance is required given the new risks caused by the war.** Bank capital and liquidity have remained high, and capital buffers have been further bolstered during the 2021 Supervisory Review and Evaluation Process cycle. Non-performing loans have been low and declining. Direct exposures of the financial sector to Russia, Ukraine and Belarus are limited, but the full extent of the indirect links and the associated risk factors are harder to assess. Therefore, supervisors should remain focused on conducting comprehensive and frequent bank portfolio reviews and risk assessments and should integrate them with updated stress-testing scenarios. The effects of high inflation on credit risk and bank funding should also be continually monitored. Going forward, vulnerability assessments, monitoring, and contingency plans should be tailored to the key security risks and should particularly prioritize cybersecurity.

**The macroprudential stance is appropriate, but careful monitoring of housing market developments is needed.** The new countercyclical buffer framework, which will take effect in December 2022, entails a tighter effective stance. This appears appropriate given the state of the housing market and continued upward momentum in house prices and credit, which has not slowed recently, including during the early phase of the war in Ukraine. The case for further macroprudential action should be continually re-assessed in line with cyclical and housing market conditions, which would depend on the evolution and impact of the war in Ukraine and for now is subject to large uncertainty. Careful monitoring of the housing market should continue, as well as that of the share of loans with debt-service-to-income ratios close to the regulatory limit. The government's recent tightening of the eligibility criteria of the housing loan support program in March 2022 would help better target support.

**AML-CFT activities are progressing well, but supervisory capacity needs to be continually enhanced.** Risks are being pro-actively addressed through supervisory and legislative actions. The rapid rise of virtual asset service providers (VASPs) entails substantial AML/CFT risks and supervision challenges, as highlighted by the 2020 National Risk Assessment. The amendments to the AML/CFT regulation which came into force in March 2022 aim to strengthen the supervision of VASPs. The law on crypto-assets and crowdfunding services to be considered by parliament in the fall is expected to further limit the risks in the Fintech sector, in line with the EU proposal on markets in crypto-assets (MiCA). The Moneyval assessment is ongoing, and its results are expected at around the end of the year. In that context the mission sees the ongoing strengthening of the Financial Intelligence Unit (FIU) capacity as appropriate.

*The mission would like to thank the Estonian authorities for their warm hospitality, close collaboration, and insightful discussions.*