INTERNATIONAL MONETARY FUND

Republic of Estonia: Staff Concluding Statement of the 2016 Article IV Mission

October, 24, 2016

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.

Thanks in part to strong institutions and determined reforms, the Estonian economy has delivered impressive gains in living standards over past decades. Nonetheless, productivity growth has been soft in recent years, while wages have increased rapidly, which is starting to dent competitiveness. Efforts to boost productivity could be stepped up further while wage growth must remain in line with fundamentals, to ensure continued durable growth whose benefits are widely shared. Public policy has a critical role to play in this process.

1. Economic growth is set to recover as the effects of adverse shocks wear off. The pace of GDP expansion has lately disappointed. Weak dynamics in key trading partners, the hiatus in drawings of EU-funds in the transition from the 2007-13 to the 2014-20 framework, and challenges in the oil shale sector have been formidable headwinds that should subside going forward. With private consumption likely remaining robust, growth should strengthen through the remainder of the year to reach 1.5 percent in 2016 and 2.5 percent in 2017. Slack in the economy is estimated to be small and concentrated in the export sector, meaning that external demand and expansion of the economy's potential will be the main contributors to future growth.

2. Risks to this outlook are skewed to the downside. Economic prospects for trading partners are more likely to be weaker rather than stronger relative to the baseline. On the domestic front, continued divergence between productivity and labor cost developments in Estonia could undermine exporters' ability to profitably tap into foreign demand. Moreover, robust growth of Estonia's economic potential cannot be taken for granted.

Boosting Productivity

3. Productivity growth has been affected by negative shocks, but persistently subdued performance over several years suggests that underlying dynamics may also have lost some of their previous strength.

4. There may be scope to scale up productivity promoting programs. Estonia already has a lot to offer investors, and several commendable new initiatives that will make the country even more attractive are in train: more public investment is planned in the 2017 draft budget, which should help fill some remaining infrastructure gaps; local government reform aims to improve service delivery; and the Company Development Program is assisting promising firms to advance. Nevertheless, more could be done to increase the private sector's take up of existing programs for innovation and learning through financial incentives and easing eligibility criteria. Active labor market programs also remain modest by European standards.

5. There may be scope to better leverage Estonia's strong institutions. The business-friendly environment, high public investment, stability-oriented policy making, and very strong public finances are all highly attractive features. To help ensure commensurate results, a strong productivity unit in the Prime Minister's office could be set up that reviews, monitors, and guides the various productivity promoting programs. In this context, the recent establishment of a productivity working group is a positive development.

Keeping Wages Anchored in Fundamentals

6. The current divergence between labor cost and productivity developments is unsustainable. A continuation would put competitiveness further at risk and could increasingly shift resources into nontradable sectors where productivity growth may be lower. Rapid wage growth mainly reflects labor market tightness that only additional labor supply can permanently address, but government wage policies and momentum are also playing a role.

7. Expanding labor supply is the priority. The ongoing reform of the disability pension system is a commendable step in this context that should gradually unlock resources as it phases in over the next few years. With government accounting for a relatively large share of employment compared to peers, there is scope to reduce its work force faster than planned, freeing resources for the private sector. Loosening restrictions on immigration and mobilizing labor resources outside urban centers is also economically attractive.

8. The public sector needs to be careful not to persistently front run general wage developments. In the last three years, government wages grew significantly faster than in the private sector and minimum wages have now been hiked by ten percent five years in a row.

This risks unmooring wages from fundamentals through spillover and signaling effects. Moreover, expectations for rapid wage convergence with Western Europe are not consistent with the current slower pace of productivity gains.

Supporting the Economy with Prudent Fiscal Policy

9. Public finances remain in excellent shape, providing valuable buffers in case of cyclical downturns or volatility in global financial markets. Public gross debt runs at a low 10 percent of GDP and is broadly covered by liquid reserves. Thanks to a revenue-rich composition of growth and lower-than-planned investment, the public finances are set to overperform this year, with the fiscal balance likely to reach a surplus of 0.8 percent of GDP. Current fiscal plans for next year would reduce the surplus, mainly on account of higher investment, but it would still amount to an estimated 0.4 percent of GDP. The corresponding surplus in structural terms would be larger than that.

10. Strong public finances provide scope to act in selected areas, while remaining well within the limits of Estonia's strict fiscal rules. Considering the state of the economy, measures that would fuel already high wage growth or would stimulate domestic sectors that are already operating near their capacity limits are neither necessary nor desirable. Instead, the emphasis should be on measures that strengthen productivity and external competitiveness. A moderate scaling up of pro-growth measures in line with what the private sector can usefully absorb and the public sector efficiently provide should be considered. In addition, advancing the cut in social security contributions already planned for 2018 would be a welcome boon for external competitiveness.

Preserving Financial Stability

11. Financial soundness indicators are strong and banks are expanding lending to the private sector at an appropriate pace. Capitalization, liquidity, and returns are at comfortable levels. The quality of assets is high. Loans and leases are being extended at a rate of around 6 percent per year, providing sufficient resources to invest. The recent deceleration in real estate prices in response to increased real estate supply is welcome.

12. There are no immediate risks to financial stability and efforts to minimize potential spillovers from vulnerabilities in Nordic parent banks should continue. The Nordic Baltic Financial Stability Group is a valuable cooperation platform that is rightly being revitalized. Supervisors from the ECB, which have direct responsibility for Estonia's largest banks, should join the group. Cooperative agreements among the relevant authorities are needed regarding liquidity support and also to ensure financial stability in all countries is protected in event of resolution. Recovery and resolution plans should be finalized expeditiously and

should recognize the systemic nature of subsidiaries in host countries even when they constitute only a relatively small share of the operations of cross-border banking groups.

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The mission team is grateful for the engaging discussions with the Estonian authorities and other counterparts and for their generous hospitality.