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2014 ARTICLE IV CONSULTATION—STAFF REPORT; PRESS RELEASE; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE REPUBLIC OF ESTONIA

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2014 Article IV consultation with the Republic of Estonia, the following documents have been released and are included in this package:

- **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on May 5, 2014, following discussions that ended on March 12, 2014, with the officials of the Republic of Estonia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on April 11, 2014.
- **Informational Annex** prepared by the IMF.
- **Press Release** summarizing the views of the Executive Board as expressed during its May 5, 2014 discussion of the staff report that concluded the Article IV consultation.
- **Statement by the Executive Director** for the Republic of Estonia.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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REPUBLIC OF ESTONIA

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION

April 11, 2014

Estonia's rapid recovery from the crisis continued at a slower pace in 2013 while fiscal policy continues the near-balanced budget policies of recent years with a deficit of 0.2 percent of GDP in 2013 and 0.4 percent of GDP expected in 2014. Net debt is near zero and gross public debt is roughly 10 percent of GDP, so fiscal issues aren't pressing. The main domestic risk is from rising labor costs.

KEY ISSUES

Prudent fiscal policies with near-balanced budgets over the cycle have reduced gross public debt to about 10 percent of GDP. These policies have also led to a pro-cyclical fiscal stance, with unsustainable increases in spending during the boom and a sharp contraction during the crisis. However, the new budget framework with a target of a structural fiscal balance or surplus should prevent excess spending in upturns and allow full operation of automatic stabilizer in downturns.

Legislation in parliament would establish the Eesti Pank (the central bank) as the macroprudential authority and provide it with a full toolkit of macroprudential instruments. However, Nordic banks dominate the system and membership in the Banking Union, limiting Estonia's scope for unilateral action. In this context, the authorities need to strengthen the Nordic-Baltic cross-border supervisory collaboration and integrate the ECB into them.

Labor costs have been rising since 2012, and recent large increases in minimum wages and wages in education and health may be putting additional upward pressure on economy-wide wages and competitiveness. The authorities should refrain from further large wage increases until it is clear that they aren't undercutting competitiveness.

Structural unemployment remains high, and the authorities should continue to implement education, training, and other initiatives to encourage foreign and domestic investment. Consideration should also be given to policies that reduce the tax wedge, particularly for lower-wage workers.

Approved By
European Department

Discussions on the 2014 Article IV consultation mission were held in Tallinn from February 28 through March 12, including a meeting in Riga, Latvia with the representatives of the three Baltic countries on March 4, 2014 as a part of the Baltic Cluster report discussions. The Estonia team met with President Ilves, Prime Minister Ansip, Finance Minister Ligi, Bank of Estonia Governor Hansson, and other senior officials as well as the Parliamentary committee on Finance, labor and employers organizations, and non-governmental think tanks. The team comprised Mr. Dorsey (head), Messrs. Abdoun and Augustyniak (both EUR) and Mr. Choi (ICD). Mr. Lindpere (OED) participated in the meetings.

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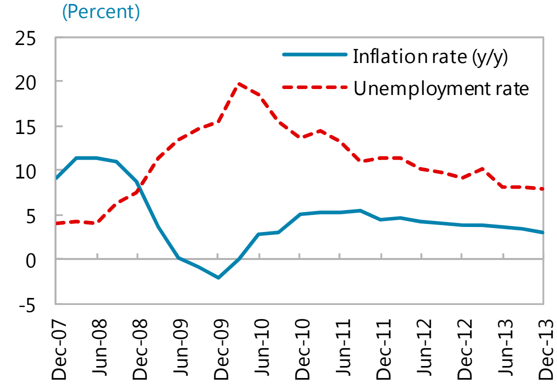
CONTEXT AND OUTLOOK

A. Recent Developments

1. Estonia has been governed by coalitions led by the center-right Reform Party since 2005, but a new coalition of center-right and center-left parties was formed on March 26, 2014. On March 4, Prime Minister Andrus Ansip announced his resignation after nine years in office, and the center-right senior partner in the previous coalition has replaced its more conservative junior coalition partner with the center-left Social Democrats. There is broad consensus within Estonia on a conservative fiscal policy stance, and the change in the ruling coalition is not expected to result in substantial changes to economic policy apart from some changes in social benefits and employment taxes. New elections are due in March 2015.

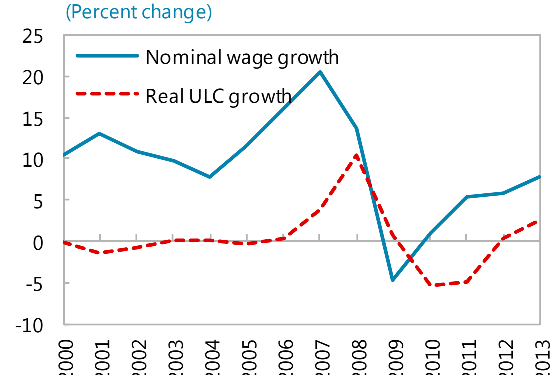
2. Estonia's recovery from the crisis continued in 2013 but at a slower pace. Preliminary data indicate that growth was 0.8 percent in 2013, with a deceleration during the year (Table 1 and Figures 1 and 2). Private consumption provided the main support for growth, while net exports made a negative contribution. Inflation declined gradually to about 3½ percent (period average) in 2013, but remains above the euro average.[1] Some of the slowdown is due to one-off factors, and there are unexplained anomalies in the national accounts data (e.g., a large deflator and unusual changes in implied taxes and subsidies). These anomalies and other indicators from tax revenue and labor market data have led most official and private analysts in Estonia to believe that the actual 2013 growth rate was higher than the current official figure.

Estonia: Inflation and Unemployment
(Percent)



Source: Haver.

Growth of Wages and Labor Costs
(Percent change)



Sources: Haver; and national authorities.

3. Unemployment continued to fall in 2013. The period average unemployment rate dropped 1.4 points to 8.6 percent in 2013 (based on the labor force survey) with the number of registered unemployed persons falling by a similar proportion. The unemployment rate is now roughly half of the 2010 peak. In contrast to many other advanced economies, this has taken place against a backdrop of a rising participation rate since the boom, encouraged in part by enhanced benefits for the

[1] Annex I of the 2013 Article IV Staff Report discusses Balassa-Samuelson and other factors that might influence the inflation differential.

unemployed. The Eesti Pank estimates that the unemployment rate would be near 5 percent had the participation rate remained at 2006–07 levels.

4. **Wage growth accelerated and outstripped productivity growth as labor market conditions tightened.** Nominal wage growth accelerated to 7.6 percent in 2013, resulting in an increase in real unit labor costs of 2.5 percent relative to 2012.

5. **On balance, the economy seems to be roughly at its potential level.** Estimates of potential using a production function method and official national accounts data show a small output gap, while evidence from the labor market suggests that the economy may already be below the NAWRU. However, the conflicting signals between national accounts and other data create more than the usual amount of uncertainty as to where the economy is relative to the potential output level, in particular whether it is closer to potential than the measured level or even above potential.

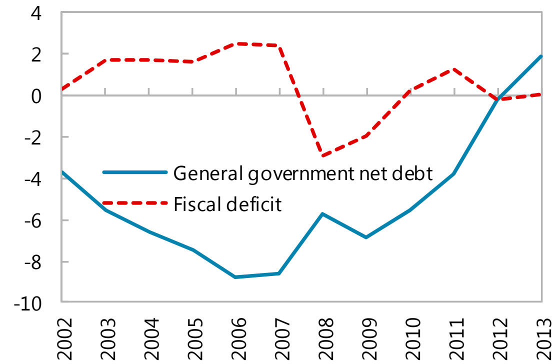
6. **The external sector balances are broadly appropriate and the net international investment position (IIP) is strengthening (Table 3 and Figure 3).** The current account deficit is small and shrinking and exports and export market shares have been growing steadily. The key factors influencing exports are moving in different directions; exports based on processing fuels imported from Russia have declined sharply, although value added is low in fuel processing. Exports excluding these goods for processing rose, although their growth rate decelerated in 2013. On the other hand, export market shares and value added in exports are increasing. But the trade balance deteriorated slightly in 2013 due to weakness in demand from some key export markets, notably Finland, and rising imports from robust private consumption demand in Estonia. Gross external debt fell sharply in 2013 and net external debt of the economy is now negative, although the IIP position remains negative due to the large stock of FDI.

7. **Indicators of competitiveness are generally good, but rising wages and producer prices are putting pressure on price competitiveness**. Real effective exchange rate indices based on unit labor costs remain well below their pre-crisis peaks (particularly for manufacturing) but they have been rising in 2012–13 (Figure 4).

8. **The exchange rate is broadly appropriate and in line with macroeconomic conditions and policies.** EBA estimates are not produced for Estonia, but team estimates based on CGER-like methodology show mixed results with some indicators suggesting an overvalued rate and others suggesting an undervalued rate. These results, together with the evidence on external sector flows and stocks, and competitiveness indicators, point to a generally stable and sustainable external position as well as a broadly appropriate exchange rate.

9. **Fiscal policy has remained conservative throughout the cycle (Tables 2 and 3 and Figure 4).** The deficit never exceeded 3 percent of GDP during crisis, and the budget has been in near balance from 2010 onwards, with the 2013 deficit at 0.2 percent of GDP. Gross public debt was largely unchanged at just under 10 percent of GDP while net public debt is near zero. While this near-balanced budget policy has kept public debt low, it has also added a pro-cyclical bias to fiscal policy.

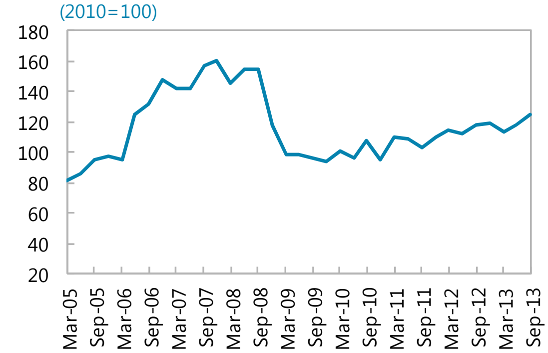
10. Estonia's banks and their Nordic parents are well capitalized, liquid, and have low levels of non-performing loans. The capital adequacy ratio remains high at 20 percent of risk-weighted assets at end 2013, and non-performing loans have fallen to 1.5 percent of the portfolio. With the loan-to-deposit ratio now just close to one, the banking system appears to have reached a sustainable equilibrium (Figure 6).



Source: National authorities.

11. Credit growth has resumed, but credit demand remains subdued. Credit growth has been positive but modest for non-financial corporations since mid-2012. While the banks have the capacity to increase lending, both business surveys and balance sheet data indicate that corporations are being cautious in their investment plans, and they are generally able to finance investments from retained earnings.[2]

12. The housing market is recovering from a very sharp decline during the crisis, but prices and household leverage are well below their peak levels. The housing market peaked in 2007 before house prices lost roughly half of their value by 2009. Prices have risen since then, but they are roughly midway between the peak and the trough. Loan-to-value ratios on new loans have fallen from roughly 100 percent of the purchase price before the crisis to roughly 60 percent since 2010. More generally, households are repairing their balance sheets and are cautious about new borrowing, although credit growth turned positive for households in late 2013. Gross household debt is still high, even after declining sharply since the crisis, but household net financial assets are positive (Table 7).



Source: BIS.

13. Estonia generally gets very high scores on cross-country evaluations of structural reform. For example, the flexibility of the Estonian labor markets cushioned some of the impact of the crisis and euro area recession on employment through downward flexibility in nominal wages in 2009–10. However, structural unemployment remains high.

2 An analysis of credit growth across the Baltic countries and a discussion of alternatives to bank financing can be found in the Chapter II of the Selected Issues paper for the Baltic Cluster Report.

Box 1. Estonia: External Stability Assessment

Estonia's real exchange rate has remained broadly in line with the fundamentals, although with some vulnerabilities on the horizon. Models based on medium-term equilibrium current account balance point to undervaluation, while direct assessment of the equilibrium real exchange rate suggests an overvaluation. An average of these estimates indicates a small overvaluation (about 5 percent). If the equilibrium real exchange rate estimate is discounted given the view that it might exaggerate overvaluation, the margin of overvaluation would shrink. However, the wide range of values from different approaches imply large confidence intervals that would preclude a firm conclusion on over- or under-valuation.

REER Assessment
(percent)

	Current assessment	2013 Art IV
Macrobalance approach	-5.3	-5.6
External Sustainability approach	-7.4	-9.9
Equilibrium Real Exchange Rate approach	17.6	15.2
REER deviation from historical average	6.8	8.0
Mid-point overvaluation range	5.1	2.6
Memorandum items (% GDP)		
Underlying current account	-1.2	-0.7
Equilibrium current account (MB)	-1.3	-1.3
Equilibrium current account (ES)	-2.3	-3.2
Mitigating factor	2.3	1.9

Source: IMF staff estimation.

Price-and cost-based indicators confirm gentle decrease in competitiveness. Having declined significantly in 2010–11, the ULC has been climbing again as real wage growth has outpaced productivity increases. Consequently, both ULC- and inflation-deflated REER have been slowly appreciating, with REER-CPI increasing by 2.7 percent in 2013.

After running large current account deficits during the boom, Estonia's current account has been near balance with a deficit of 1 percent of GDP in 2013. Exports continue to perform well, although demand remains weak in some of Estonia's main trading partners. In 2013, the trade deficit widened slightly, while the services surplus decreased slightly to 6.7 percent of GDP. Net export of services dominates trade balance, as Estonia capitalizes on its highly-skilled and competitive wages as well as well-developed telecommunication network. Estonia gained market share in each of its top export markets in 2013 (Finland, Sweden, Russia and Latvia).

Net FDI and transfers from the EU cover most of the current account deficit. FDI has been declining, but remained positive with reinvested earnings accounting for most FDI inflows. EU transfers are expected to pick up again in late 2014 or early 2015 with the implementation of the new EU budget for 2014–20.

Gross external liabilities are declining and net debt of the economy became negative in 2013. Net IIP liabilities were halved from the peak during the crisis years to 46 percent of GDP in 2013.

B. Outlook and Risks

14. Growth should pick up in 2014 and the medium-term. Staff project growth of 2.4 percent in 2014 supported by both external and domestic demand rising toward expected potential growth (estimated at 3 to 3.5 percent in the medium term, using a production function approach that accounts for demographic factors). The downward trend in inflation is expected to continue, toward 2 percent over the medium term, but could be slowed by increased wage pressure. This is above the euro-area average, but it is consistent with what would be expected for a country converging with its higher-income partners in the euro area.

15. Risks are tilted moderately toward the downside and mostly relate to trade. Continued contraction in Finland, or lower-than-expected growth in Sweden or Latvia could slow Estonia's growth through lower exports or FDI. Trade or other shocks from Russia and other CIS countries could also drag down exports or otherwise depress growth. Trade with Russia is dominated by energy imports, much of which is fuels that are re-exported after processing and natural gas for which Russia is the sole supplier, and food exports, some of which are already subject to import restrictions in Russia. On the upside, higher than expected growth in Nordic-Baltic countries or other trade partners could also boost Estonia's growth.

16. A rise in interest rates from a shock in the Nordic banking system could also adversely affect Estonia. With household debt dominated by adjustable rate mortgages, such a shock would pass through quickly into household debt service, and this could lower consumer demand. Businesses would be less affected as they are increasingly self financed for their investment needs or able to get funding from foreign parent companies. However, a financial market shock outside the Nordic region would have only a limited effect on Estonia given the strong financial position of the Nordic banks and their dominance in the Estonian banking market.

17. The main domestic risk is labor market overheating. Signs of this are already evident as real wage growth is exceeding productivity growth, and this could undercut competitiveness and export growth. With a flexible labor market legal regime and low levels of unionization, these wage increases represent market outcomes.

Estonia: Risk Assessment Matrix[1]

Source of Risks	Relative Likelihood	Impact on Estonia
Side-effects from global financial conditions: • **Surges in global financial market volatility** (related to UMP exit), leading to economic and fiscal stress, and constraints on country policy settings • **Distortions from protracted period of low interest rates:** excess leverage, especially for corporates; delays in fiscal and structural reforms	High Medium	Low Spillovers would be mitigated by the financial strength of the Nordic banks. Medium Estonian households could return to the excessive borrowing patterns as observed in the run up to the crisis.
Protracted period of slower growth in advanced and emerging economies: larger than expected deleveraging or negative surprises on potential growth	High (advanced) Medium (elsewhere)	Medium Estonia could be affected indirectly through its trade exposure to Western Europe with knock on effects on output, employment, and ability to service debt. EM spillovers involving Russia could be significant.
Risks to competitiveness from real wage increase: rising unit labor costs could undercut exports if current trends continue.	Medium	Medium Rising ULCs could undercut competitiveness and weaken the export growth that has led Estonia out of the recession.
Increasing geopolitical tensions surrounding Ukraine lead to disruptions in financial, trade and commodity markets	Medium	Medium Russia accounts for a modest share of Estonian exports (11 percent), but is the sole supplier of natural gas.
Financial stress in the Nordic banking system: tensions in global funding markets or the realization of risks from weak output or a correction in housing prices in Nordic markets could induce banks to pull funding from Estonia.	Low	Medium A negative shock to the Nordic banks might result in tightened credit conditions in Estonia. If passed through to interest rates, this could depress private consumption.

1/The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 percent or more). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Authorities' views

18. While broadly agreeing with the outlook, the authorities were mostly concerned about rising wage rates in excess of productivity growth. They also expect that growth will rebound in 2014, and that inflation will decline in 2014 and over the medium-term. They agree that excessive wage growth threatened competitiveness and growth, but they noted the strong influence of much higher wages elsewhere in the EU, particularly Finland, and the ease and frequency with which Estonian workers can move to Finland as exogenous factors influencing Estonian wages that are beyond the control of the authorities. They agreed that potential fallout from events in Russia and Ukraine could affect trade with Russia, but they had not observed much immediate effect; the wide margins of uncertainty as to future developments in this conflict rendered any assessment of any economic impact highly speculative.

POLICY DISCUSSIONS

Estonia's policies and policy agenda since the last Article IV consultation have been marked by continuity in policies (e.g. near-balanced budgets, steady implementation of their own policy agenda, the EU fiscal compact and the Basel III reforms (Box 2)). With output near potential and signs of overheating in labor markets, the consultation focused on the appropriate fiscal stance and labor market policies, and on changes to fiscal and financial sector frameworks to help Estonia better manage within the constraints of the euro zone.

A. Fiscal Policies

19. The fiscal stance in 2014 and medium-term path remain appropriate. With a projected headline deficit of 0.4 percent of GDP and an estimated structural surplus of 0.7 percent of GDP, the fiscal stance in 2014 is largely unchanged from 2013. The budget will maintain Estonia's strong public finances and keep Estonia well within the limits set by its commitments under EU agreements. Over the medium-term, the fiscal stance will further reduce public debt and restore the net financial asset position of the government (see DSA, Figures 7 and 8).

20. Estonia enacted a new State Budget Law in March 2014 that implements provisions of the EU Fiscal Compact. The structural surplus target embodied in the new budget Law could help to address the previous pro-cyclical patterns on fiscal policy. Specifically, the requirement for a structural surplus can help to prevent increases in expenditure during good times that cannot be sustained over the longer-term. While adherence to the structural surplus target would not require counter-cyclical spending during downturns, it provides scope to allow automatic stabilizers to operate fully. The government's plans to keep the structural surplus well above the medium-term objective for the Fiscal Compact. This could keep the government's balance sheet strong and provide a margin to accommodate negative fiscal surprises or disagreements as to whether the target is met based on alternative estimates of the structural balance. Care must be taken to ensure that the margin relative to the target does not provide a channel through which to reintroduce procyclicality. Legislation was approved in late March 2014 to create an new, independent fiscal council in line with the Fiscal Compact.

Authorities' views

21. **The authorities were more cautious than staff on allowing automatic stabilizers to work fully in downturns.** While they accepted the argument for countercyclical fiscal policy, they felt that this needed to be weighed against the desirability of increasing fiscal reserves in an economy with a declining and aging population that has been exposed to large shocks in the past. They also consider fiscal stimulus rather inefficient because much of it leaks out of the country due to the high import share in the economy. On the fiscal council, the authorities believe that the formation of new independent institution will further bolster Estonia's resilience and credibility on fiscal policy.

B. Financial Sector Policies

22. Risks to the banking sector remain, but appear contained. The risks on the domestic side stem from possibly weak output growth which may negatively affect credit quality. However, the stress test conducted by the authorities suggests that potential impacts from macro shocks would be largely absorbed by high capitalization. Externally, financial stress in the Nordic banking system, possibly due to the tensions in global funding markets or a correction in housing prices, could induce banks to pull funding from Estonia. However, strong deposit growth in Estonia provides a substantial portion of local funding for now.

23. The Estonian authorities are implementing the new capital and liquidity provisions under Basel III. The capital conservation buffer, the systemic risk buffer, and the countercyclical capital buffer will be implemented shortly after pending legislation is enacted. The capital conservation buffer (of 2.5 percent EU-wide) is expected to be immediately adopted without a transitional period. The systemic risk buffer is expected to be set at 2 percent and the countercyclical buffer is expected to be set at zero initially. The liquidity coverage ratio is to be implemented by January 1, 2015. These actions are not likely to substantially affect the banking sector which is already highly capitalized and liquid. They would complete most of the outstanding domestic agenda on the Basel-III reforms and go a very long way toward ensuring financial sector stability.

24. Estonia is now well advanced in the process of establishing a more complete and stronger macroprudential toolkit. The draft amendments to the Eesti Pank Act and the Credit Institutions Act would establish the Eesti Pank as the macroprudential authority, give it the macroprudential tools specified in the CRD IV, and provide the authority to set macroprudential limits such as loan-to-value and debt-service-to-income ratios requirements rather than guidelines.

25. Implementation of the EU Banking Union will require cooperation between Estonia, the ECB, the Nordic home country supervisors of Estonia's major banks, and the Nordic-Baltic financial structures. With the implementation of the Single Supervisory Mechanism (SSM) in November 2014, the three subsidiaries (SEB, Swedbank, and DNB) will come under direct supervision of the ECB. The Nordic bank branches (Danske and Nordea) would remain under the supervision of the Swedish and Danish authorities respectively.[3] Then, modalities should be in place for close consultation between the Estonian authorities, ECB regulators and the Nordic regulators of the parent banks, both on supervision and on setting regulatory capital and liquidity requirements. The current framework of Nordic-Baltic cooperation on bank supervision and policy (including Nordic-Baltic Stability Group and Nordic-Baltic Macroprudential Forum) will need to be adapted to the Banking Union.

Authorities' view

26. The authorities' view is that the banking system is sound, but they also feel the need to closely monitor it. The early adoption of the capital conservation buffer reflects the authorities' confidence on banking sector soundness, while they plan to assess SSM banks (SEB, Swedbank, and DNB), as well as small local banks with relatively rapid credit growth, through the ECB-led asset quality review later this year. The authorities value the importance of the more complete and strengthened macroprudential toolkit for banking supervision. The authorities believe that the Banking Union will create a positive confidence effect on Estonia's banking sector and that Nordic-Baltic cooperation has worked well and needs to be preserved.

C. Labor Markets

27. The government should be prepared to respond to further evidence of deteriorating competitiveness from real wage increases. While the first of three roughly 10 percent annual increases in the minimum wage in 2013–15 probably had minimal effect on average wages, the two subsequent increases may become more binding on actual wages. Also, while wages are very largely market determined in Estonia, the minimum wage increases and public health and education wage increases may have had a demonstration effect beyond their direct impact. Until it is clear that recent signs of worsening price competitiveness are not undercutting net exports, the government should refrain from large public sector wage hikes or agree to minimum wage increases after 2015.

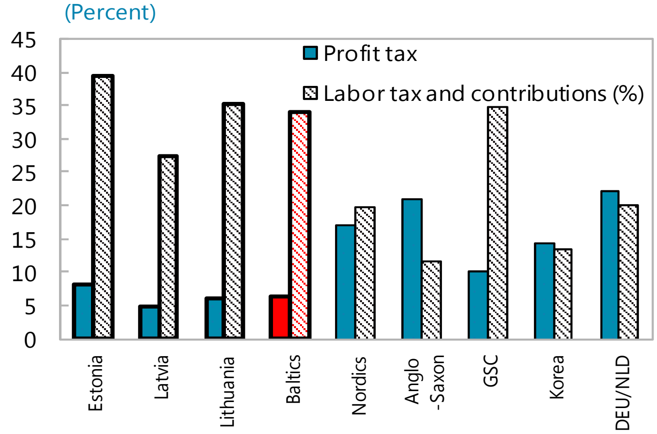
28. Estonia's high level of structural unemployment needs to be addressed. While there is considerable evidence that the Estonian economy is now at or near the level of structural unemployment, the fact that this is taking place with the unemployment rate still above 8 percent suggests scope for medium-term policies to reduce the structural rate. Estonia has a very flexible labor market, but still structural unemployment remains higher than in countries with similar labor market policies. Mismatches in workforce skills and education and the background sought by employers seem to be keeping unemployment high even in good economic times. Some active labor market policies to address skills mismatches and keep people in the labor force are already in place. The authorities are addressing education through several initiatives, including eliminating university tuition for full-time students. The work of the Unemployment Insurance Fund on training

[3] The three largest banks (local banks or subsidiaries of foreign banks) in each euro area member will come under ECB supervision. For Estonia, these are SEB, Swedbank and DNB.

and counseling to encourage effective labor force participation by youth, the disabled, and the long-term unemployed has been expanded very substantially to integrate these more difficult segments of the working age population. Specifically, active labor market expenditures per unemployed person rose sharply between 2010 and 2012 in almost every category, with training expenditures (the largest category) rising to more than eight times the 2010 per person level by 2012. More efforts are needed to change the composition of specialization in secondary and tertiary education, but this is inherently a long-term project.

29. Labor taxes and contributions may be an obstacle to reducing unemployment, particularly for low wage workers. The tax wedge is high in Estonia even relative to the Nordics and much higher than in the "Anglo-Saxon" (i.e., majority Anglophone) OECD countries. Labor taxes as a share of business income are particularly high relative to profit taxes for Estonia and this is true in comparison to both the Nordics and Anglo-Saxons. Evidence from other countries suggests that reducing the labor tax wedge would be likely to reduce structural employment. In this context, lowering the tax wedge on lower-wage workers (where unemployment is highest) should be given serious consideration.[4] The fiscal costs could be offset by tax reforms, in particular through elimination of regressive tax exemptions or the introduction of property taxes) that preserve the fiscal targets. Lowering the tax wedge would also contribute to containing unit labor costs and improving competitiveness.

Taxation Rates
(Percent)



Source: World Bank Doing Business.

Authorities' views

30. The authorities noted that the active labor market policies that have been gradually introduced since 2010 have contributed to the sharp decline in unemployment since then. The Unemployment Insurance Fund (UIF) has developed various assistance programs to help the registered unemployed in their job search, including counseling, disability employment services, and training. They also noted efforts being made by the Ministry of Education and Research to improve life-long learning at all skill levels for those already employed in order to foster productivity growth, and increase the number of people coming out of the education system in technical fields (e.g., science and engineering), including through cooperation between universities and the private sector. Finally, the authorities indicated that they are preparing a reform of disability benefits that would strengthen the possibilities of disabled people for (part-time) work thus increasing

[4] This is discussed for Estonia and the other Baltic countries in the Baltic Cluster Staff Report prepared in conjunction with this report and in particular in Chapter IV of the Selected Issues Paper for the Baltic Cluster Staff Report.

employment and at the same time tighten the eligibility criteria for disability benefits and limit abuses (the number of people receiving disability benefits is close to one-sixth of the labor force).

D. Other Policy Priorities

31. Regional efforts to improve infrastructure links to Estonia's neighbors could also boost competitiveness. Infrastructure in Estonia is rated highly in international comparisons, but regional cooperation needs to be enhanced for some critical systems, such as transport and energy. While progress has been made in linking the electricity grid to Finland, more could be done to build rail links to the rest of the EU and diversify options for natural gas supply. Particularly as EU funds are potentially available to finance most of the costs for rail and gas, Estonia should coordinate with its Baltic and Nordic neighbors to better connect itself to the rest of the EU and diversify infrastructure links to be able to take advantage of better alternatives. [5]

Authorities' views

32. The authorities agreed on the importance of improving infrastructure links to the rest of the European Union, but noted the steps already taken or underway. They noted that the second electricity link had been established with Finland and that there was agreement with Finland on LNG terminals and a gas pipeline linking the two countries. Discussions on a rail link running through the Baltics and connecting them to the rest of the EU through Poland are underway.

STAFF APPRAISAL

33. The near- and medium-term outlook for Estonia is generally positive. While growth slowed in 2013, there is good reason to expect an acceleration of growth in 2014 and the medium term. Inflation has been running above the euro area average, but it is trending down toward 2 percent and remains appropriate for a country rapidly converging with its higher-income euro area partners. Export growth remains strong and competitiveness indicators are generally good, although rising unit labor costs are a source of concern and need monitoring. External risks are mostly related to trade and the outlook for growth in major export markets, although problems in the Nordic banking system could spill over into Estonia and events in Russia and Ukraine could have a negative impact through other channels.

34. The 2014 budget continues the Estonian tradition of prudent fiscal policy. The projected headline deficit of 0.4 percent of GDP is appropriate given cyclical and labor market conditions, while the structural surplus remains largely unchanged at 0.7 percent. This budget should meet the requirements of the Fiscal Compact.

[5] More extensive discussion of challenges for exports trade and joint policies to that end can be found in the Baltic Cluster Report and Chapter III of the associated selected Issues paper.

35. The structural surplus target embodied in the new Budget Law should help to address the previous pro-cyclical patterns on fiscal policy. The requirement for a structural surplus can help prevent unsustainable increases in expenditure during good times and provide scope to allow automatic stabilizers to operate, as should be done in downturns. The government's medium-term plans to keep the structural surplus well above the medium-term objective should keep the government's balance sheet strong, but they should not be used to reintroduce a procyclical dimension to policy. The new law establishing an independent fiscal council is also welcome. These policies can help to further bolster Estonia's resilience and credibility on fiscal policy.

36. The authorities' commitment to maintain a strong financial system in the face of an evolving financial architecture is welcome. The planned early implementation of the new capital and liquidity provisions is appropriate. When credit growth recovers to pre-crisis levels, raising the countercyclical buffer from zero needs to be considered. Close collaboration among the Estonian authorities, the ECB, the Nordic-Baltic sector supervisory, central bank, and governmental structures will be important to smooth Estonia's transition to the Banking Union.

37. The government should be prepared to respond to further evidence of deteriorating competitiveness from real wage increases. In this context it should refrain from additional large public sector wage hikes or agree to minimum wage increases after 2015, until it is clear that worsening price competitiveness is not undercutting net exports.

38. Estonia's high level of structural unemployment needs to be addressed. Some active labor market policies to address skills mismatches and keep people in the labor force are already in place and funding for these policies has been substantially expanded in recent years. Programs to improve the skills of those already working and increase the number of people with education in technical fields should address the shortage of highly-skilled workers and help boost productivity. Lowering the tax wedge on lower-wage workers in a budget-neutral manner should also be given serious consideration. Lowering the tax wedge would also contribute to containing unit labor costs and improving competitiveness.

39. Regional efforts to improve infrastructure links to Estonia's neighbors could also boost competitiveness. Estonia should coordinate with its Baltic and Nordic neighbors to be better connected to the rest of the EU and diversify infrastructure.

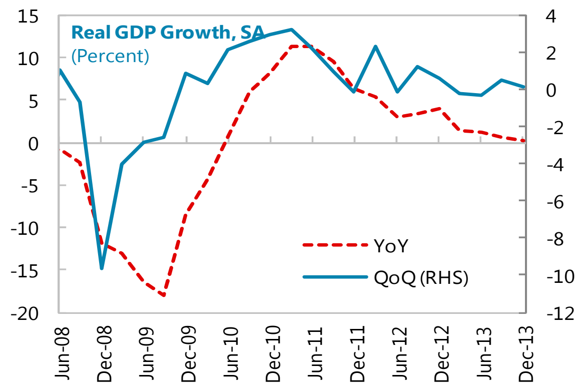
40. It is proposed that the next Article IV consultation with Estonia take place on the standard 12-month cycle.

Box 2. Actions Taken in Areas Relevant to Previous Policy Advice

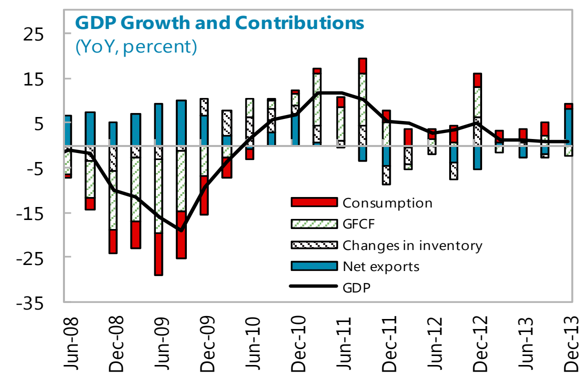
Recommendations from 2013 Article IV Consultation	Policy Actions by the Estonian authorities
As budgetary conditions allow, make room to address Estonia's medium-term economic challenges, including lowering the tax burden.	The personal and corporate income tax rates will be lowered from 21 to 20 percent effective January 1, [2015].
Adopting a fully fledged medium-term fiscal framework can help assess policy tradeoffs and avoid pro-cyclical policies.	The State Budget Act was enacted in March 2014, which provides for a medium-term fiscal objective of a structural fiscal balance or surplus, in line with the EU Fiscal Compact. The legislation also established a fiscal council and implements a corrective mechanism not included in the Fiscal Compact that requires that overruns against the medium-term objective be offset in subsequent years with a minimum adjustment of 0.5 percent of GDP per year. The medium-term budget strategy continues to provide guidance to agencies as to their budget submissions to the Ministry of Finance and medium-term budget planning.
Strengthen macroprudential policies including though early implementation of forthcoming international standards.	The capital conservation buffer, the systemic risk buffer, and the countercyclical capital buffer will be implemented shortly after pending legislation is enacted. The capital conservation buffer (of 2.5 percent EU-wide) is expected to be immediately adopted without a transitional period. The liquidity coverage ratio is to be implemented by January 1, 2015.
The authorities should consider introducing ceilings on loan-to-value and loan-to-income ratios.	Pending legislation gives the Eesti Pank full authority to set loan-to-value, loan-to-income, debt-service-to-income, and other prudential ratios as requirements rather than guidelines.
Strengthen the Eesti Pank's macroprudential authority.	The draft amendments to the Eesti Pank Act and the Credit Institutions Act will establish the Eesti Pank as the macroprudential authority.
Continue Nordic-Baltic cross-border supervisory and financial sector coordination arrangements in tandem with the Banking Union.	The Nordic-Baltic arrangements are continuing, but progress has been limited on integrating these arrangements with Banking Union structures pending greater clarity on the latter.
Continue efforts to improve education and training to reduce skills mismatches.	Funding for active labor market policies for the unemployed has been increased substantially in recent years, and plans are being developed for increasing the supply of people educated in technical fields.

Figure 1. Estonia: Real Sector Developments, 2008–13

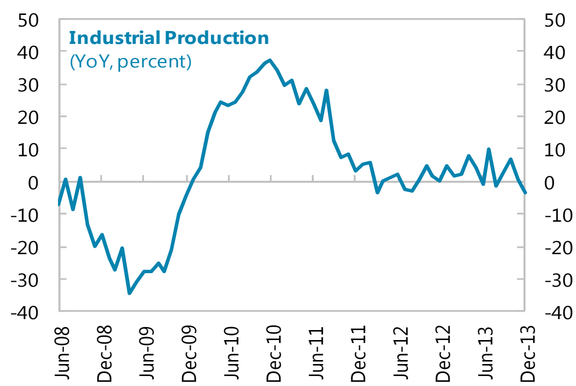
In 2013, GDP growth slowed down, ...



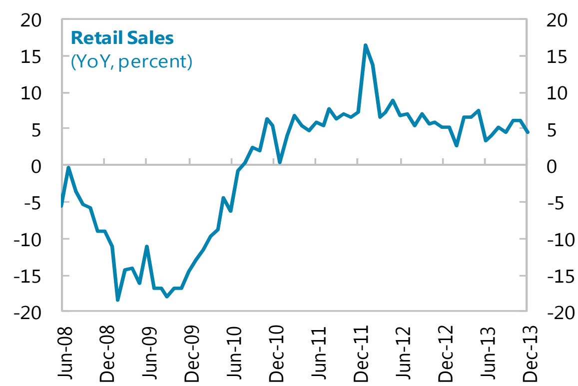
... upheld mostly by domestic consumption.



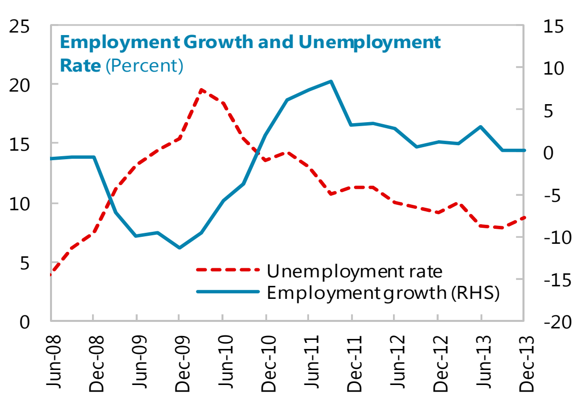
Manufacturing sector has reached a steady state, ...



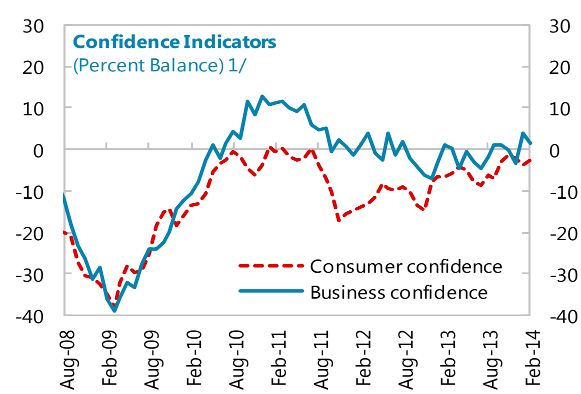
... while retail sales have been holding up ...



... reflecting declining unemployment ...



... and improving overall confidence.



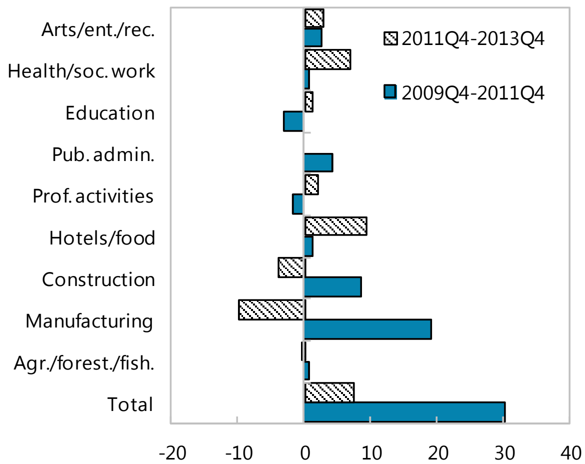
Sources: Haver; and national authorities.

1/ Balance equals percent of respondents reporting an increase minus the percent of respondents reporting a decrease.

Figure 2. Estonia: Putting the Crisis Behind, 2008–13

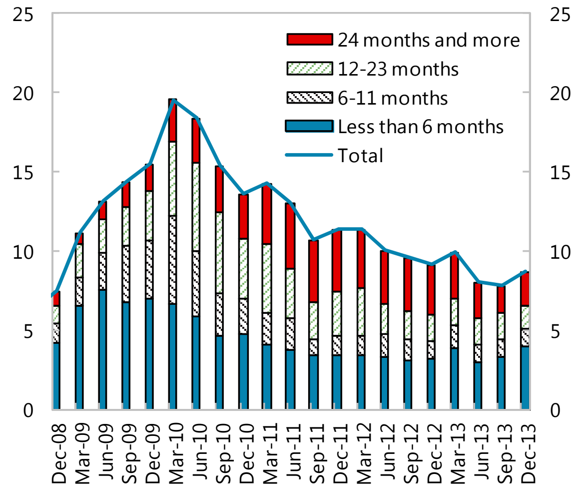
New jobs continue to be created, but in smaller numbers than before ...

Jobs, Lost or Gained
(Thousands of jobs)



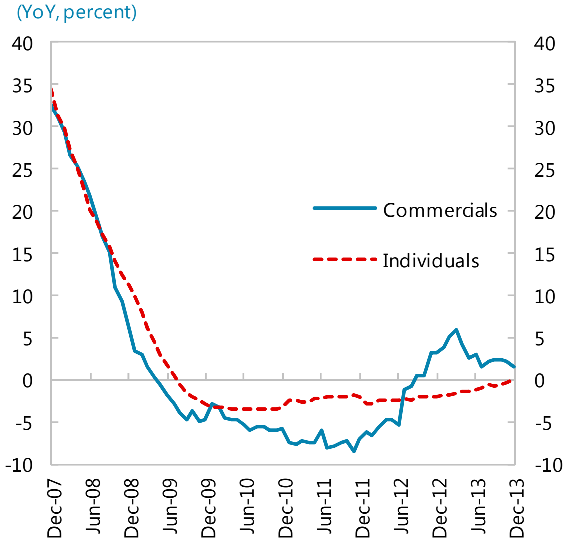
... as unemployment decreased markedly, including long-term unemployment.

Unemployment Rates by Duration
(Percent)



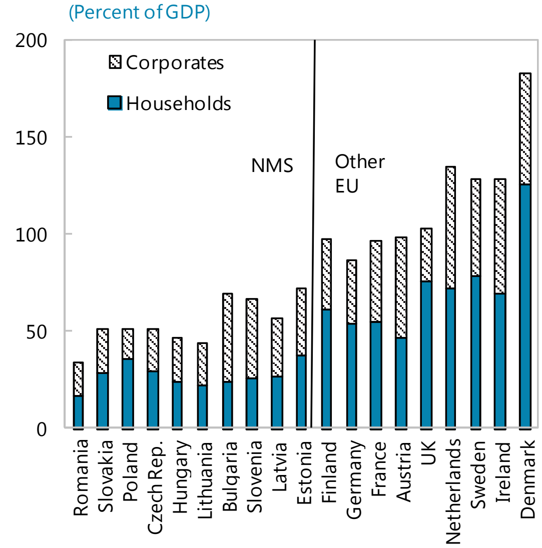
Credit growth has resumed ...

Credit Growth
(YoY, percent)



... and the level of credit is moderate for both households and corporations.

Nonfinancial Private Sector Loans, 2013
(Percent of GDP)

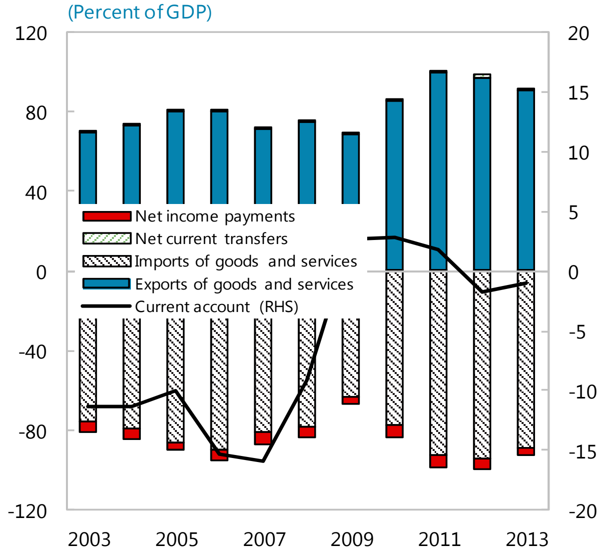


Sources: Eurostat; Statistics Estonia; and Bank of Estonia.

Figure 3. Estonia: External Developments, 2003–13

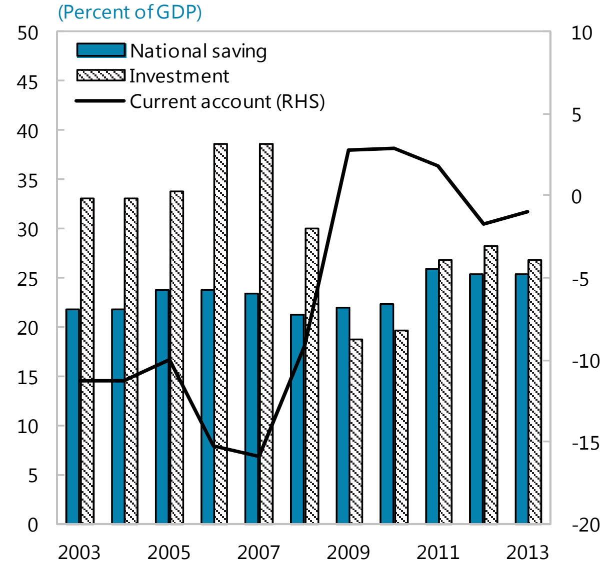
In 2013, current account deficit has improved …

Current Account
(Percent of GDP)



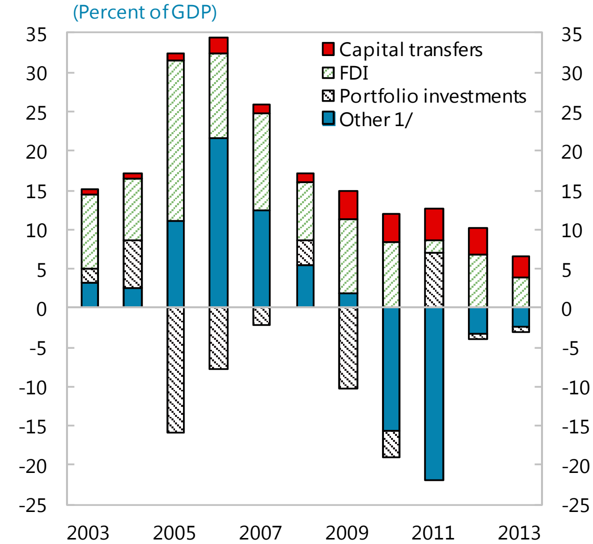
… reflecting slight deterioration in investment.

Saving and Investment
(Percent of GDP)



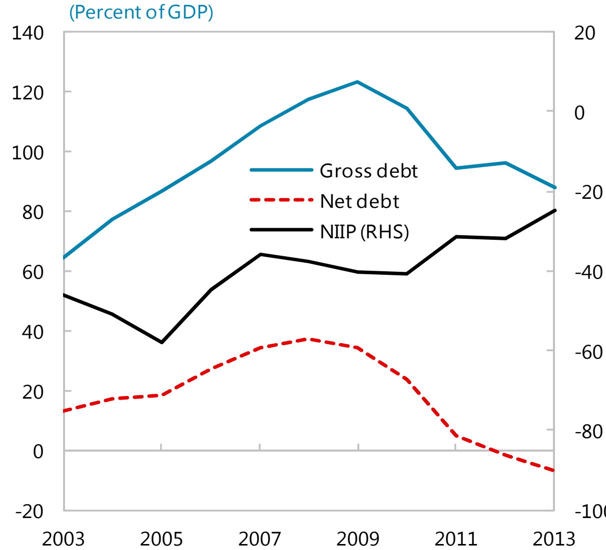
Capital outflows have moderated …

Capital and Financial Accounts
(Percent of GDP)



… while net asset positions have improved.

External Position
(Percent of GDP)

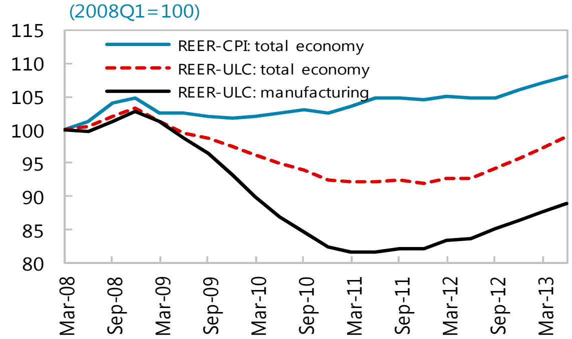


Sources: Haver; Statistics Estonia; and IMF staff calculations.
1/ Other is defined as the sum of financial derivatives, and other investments.

Figure 4. Estonia: External Competitiveness, 2008–13

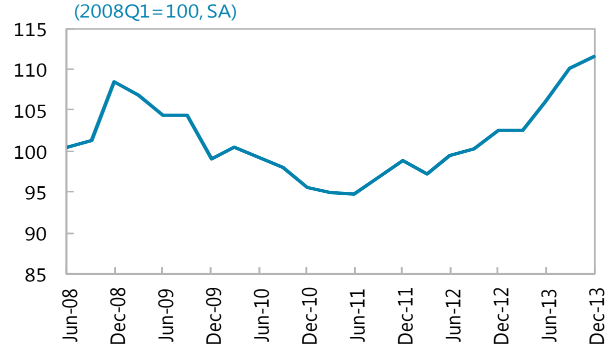
Estonia's competitiveness is gradually deteriorating ...

REER vs EU27 Index
(2008Q1=100)



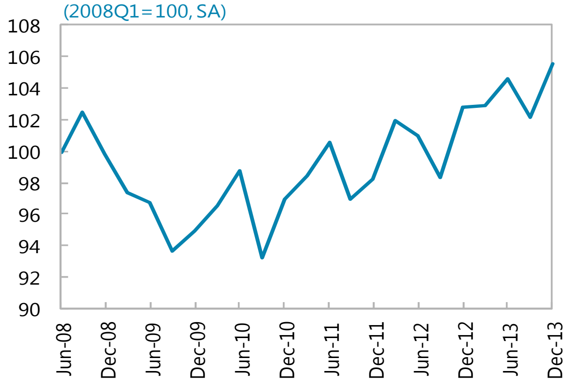
... as labor costs have been climbing up ...

Unit Labor Cost
(2008Q1=100, SA)



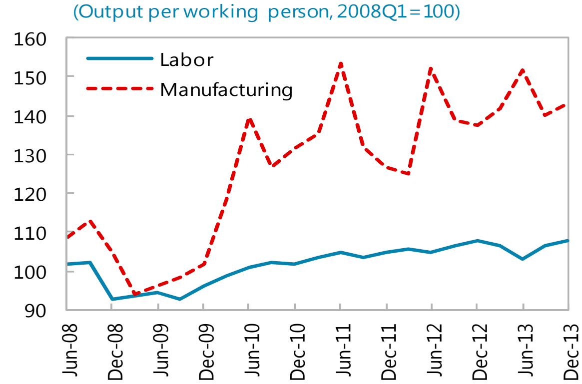
... driven by real wage increases ...

Real Wages
(2008Q1=100, SA)



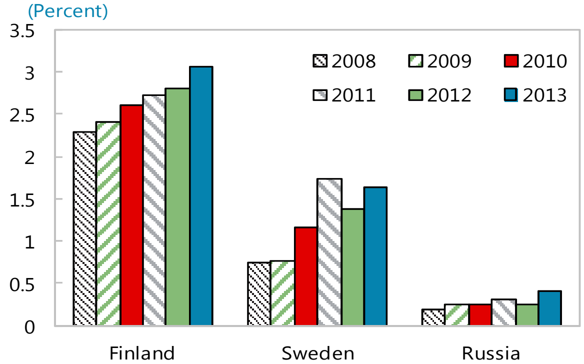
... that have outpaced gains in productivity.

Productivity
(Output per working person, 2008Q1=100)



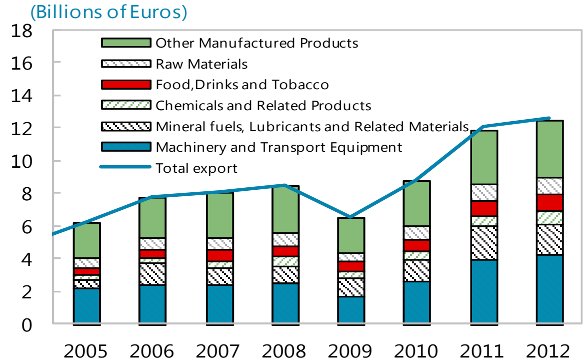
Market shares have increased slightly ...

Estonia's Market Share in Selected Countries
(Percent)



... and exports have continued to perform well.

Export Composition
(Billions of Euros)

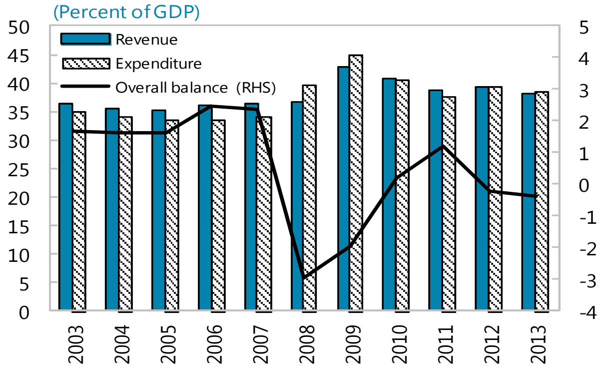


Sources: DOTS; Haver; WEO; and EU Commission.

Figure 5. Estonia: Fiscal Developments and Structure, 2003–13

2013 was another year of almost balanced budget …

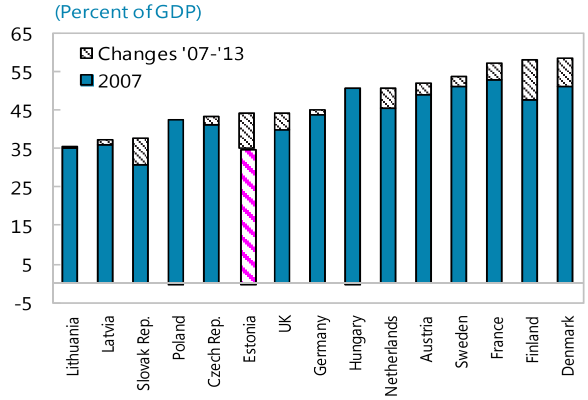
General Government
(Percent of GDP)



… have matched revenue collection.

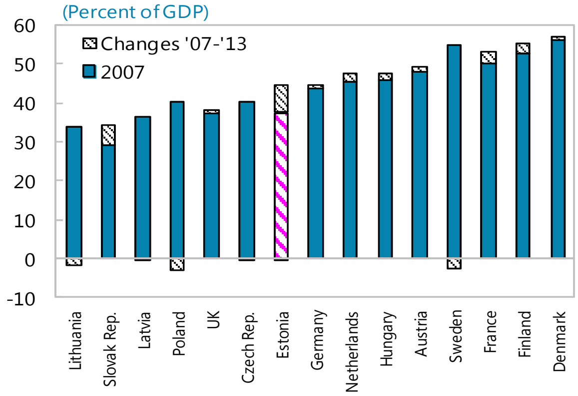
… as expenditure increases …

General Government Expenditure
(Percent of GDP)



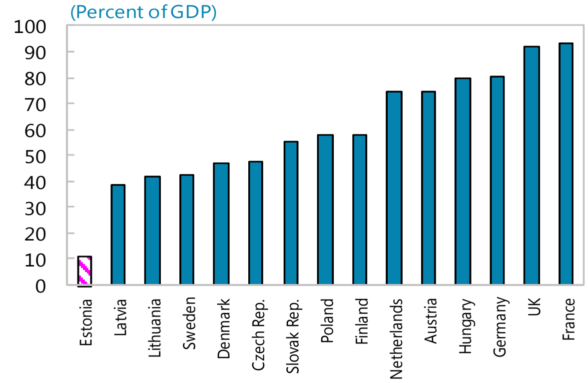
Consequently, Estonia continues to enjoy the lowest level of public debt in the EU.

General Government Revenue
(Percent of GDP)



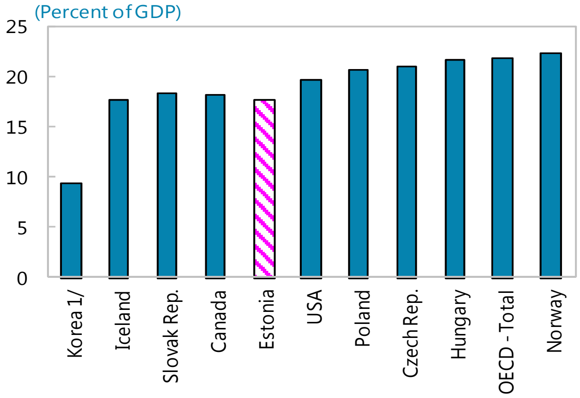
Social spending is below the OECD average, …

General Government Debt, 2013
(Percent of GDP)

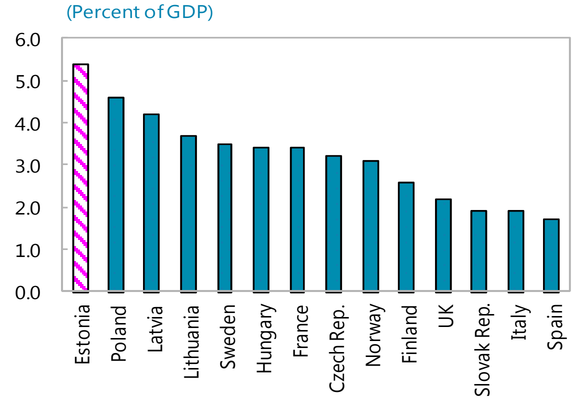


… but general government investment is the highest in the EU.

Public Social Expenditures, 2013
(Percent of GDP)



General Government Capital Expenditures
(Percent of GDP)

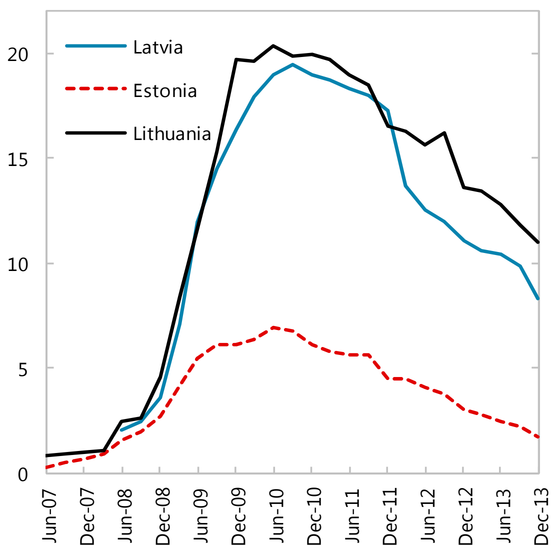


Sources: WEO; Eurostat; and OECD.
1/ Data for Korea are for 2012.

Figure 6. Estonia: Financial Developments, 2007–13

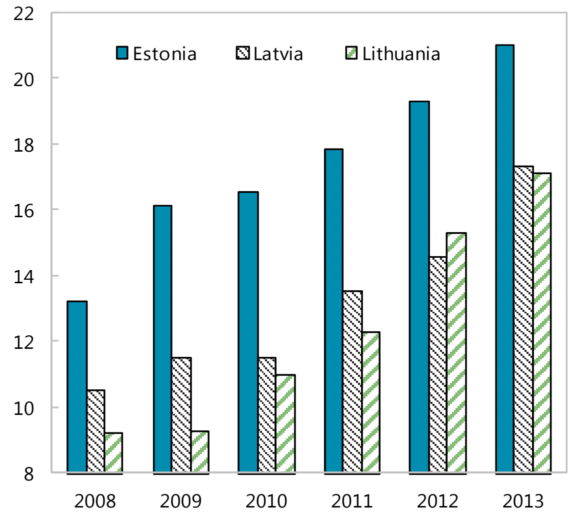
Estonian banks have relatively low and declining non-performing loans ...

Non-performing Loans 1/
(Percent of outstanding loans)



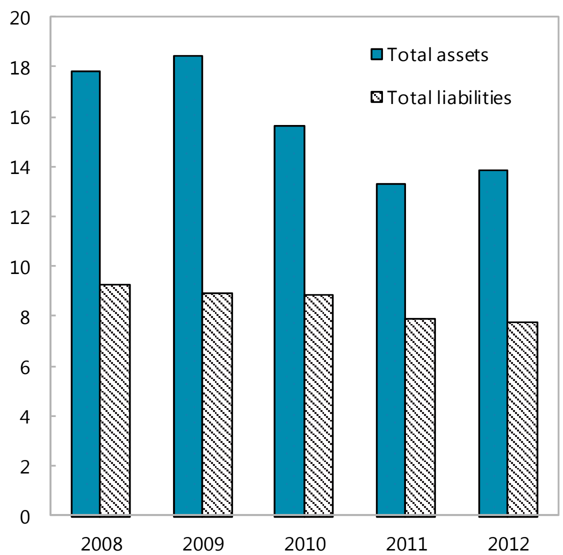
... and remain well capitalized.

Regulatory Tier 1 Capital to Risk-weighted Assets
(Percent)



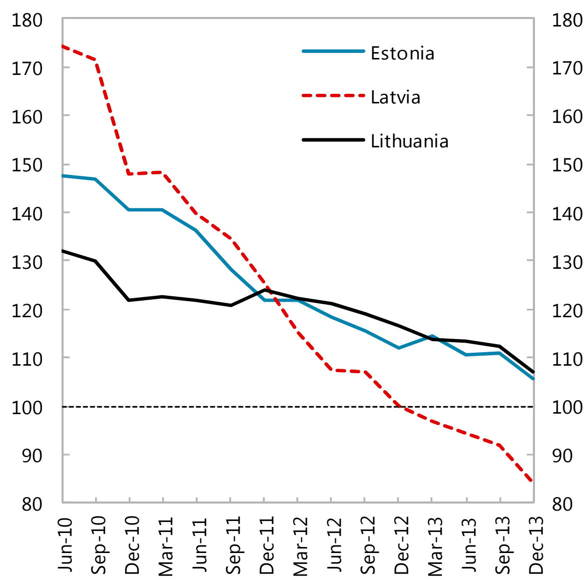
Households are repairing their balance sheets and are cautious about new borrowing,...

Households' Balance Sheets
(Billions of Euros)



... which has resulted in a decrease of loan-to-deposit ratio to a sustainable level.

Loan-to-Deposit Ratio
(Percent)



Sources: Haver; national authorities; and IMF staff calculations.
1/ In Lithuania, NPLs include impaired loans and loans past due by 60 days but not impaired; in Latvia, NPLs are loans overdue by more than 90 days; in Estonia, they are loans overdue by more than 60 days.

Figure 7. Estonia: Public Sector Debt Sustainability Analysis (DSA) – Baseline Scenario

(Percent of GDP unless otherwise indicated)

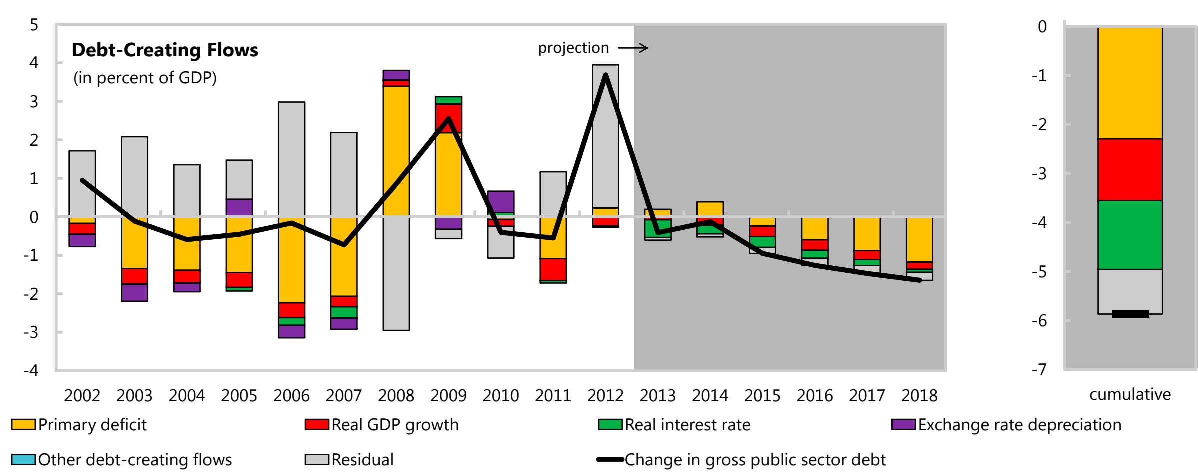
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2002-2010 [2/]	2011	2012	2013	2014	2015	2016	2017	2018
Nominal gross public debt	5.3	6.1	9.8	9.4	9.3	8.3	7.1	5.6	4.0
Public gross financing needs	0.7	0.2	2.1	0.5	2.3	1.7	1.2	0.7	0.2
Real GDP growth (in percent)	3.5	9.6	3.9	0.8	2.4	3.2	3.5	3.6	3.7
Inflation (GDP deflator, in percent)	5.1	3.0	3.3	5.0	4.1	4.7	4.4	4.3	4.1
Nominal GDP growth (in percent)	8.9	12.8	7.4	5.9	6.6	8.1	8.0	8.1	7.9
Effective interest rate (in percent) [4/]	4.3	2.2	2.9	0.1	1.6	1.6	1.8	2.2	2.7

As of April 01, 2014		
Sovereign Spreads		
EMBIG (bp) 3/		0
5Y CDS (bp)		49
Ratings	Foreign	Local
Moody's	A1	A1
S&Ps	AA-	AA-
Fitch	A+	A+

Contribution to Changes in Public Debt

	Actual			Projections							
	2002-2010	2011	2012	2013	2014	2015	2016	2017	2018	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	0.2	-0.5	3.7	-0.4	-0.1	-1.0	-1.3	-1.5	-1.6	-5.9	
Identified debt-creating flows	-0.6	-1.7	0.0	-0.3	-0.1	-0.8	-1.1	-1.3	-1.4	-5.0	
Primary deficit	-0.3	-1.1	0.2	0.2	0.4	-0.2	-0.6	-0.9	-1.2	-2.3	-0.3
Primary (noninterest) revenue and grants	36.9	38.6	39.1	38.0	37.8	37.7	37.3	36.7	36.2	223.7	
Primary (noninterest) expenditure	36.6	37.5	39.3	38.2	38.2	37.4	36.7	35.8	35.1	221.4	
Automatic debt dynamics [5/]	-0.3	-0.6	-0.3	-0.5	-0.4	-0.6	-0.5	-0.4	-0.3	-2.7	
Interest rate/growth differential [6/]	-0.2	-0.6	-0.3	-0.5	-0.4	-0.6	-0.5	-0.4	-0.3	-2.7	
Of which: real interest rate	0.0	-0.1	0.0	-0.5	-0.2	-0.3	-0.2	-0.2	-0.1	-1.4	
Of which: real GDP growth	-0.1	-0.6	-0.2	-0.1	-0.2	-0.3	-0.3	-0.2	-0.2	-1.3	
Exchange rate depreciation [7/]	-0.1	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Please specify (1) (e.g., drawdown of de	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Please specify (2) (e.g., ESM and Euroare	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	0.8	1.1	3.7	-0.1	-0.1	-0.2	-0.2	-0.2	-0.2	-0.9	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

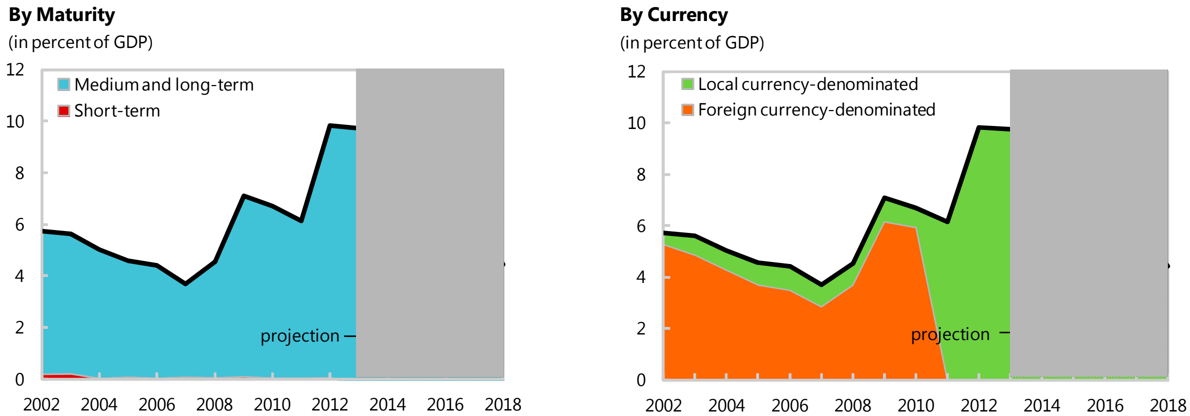
7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

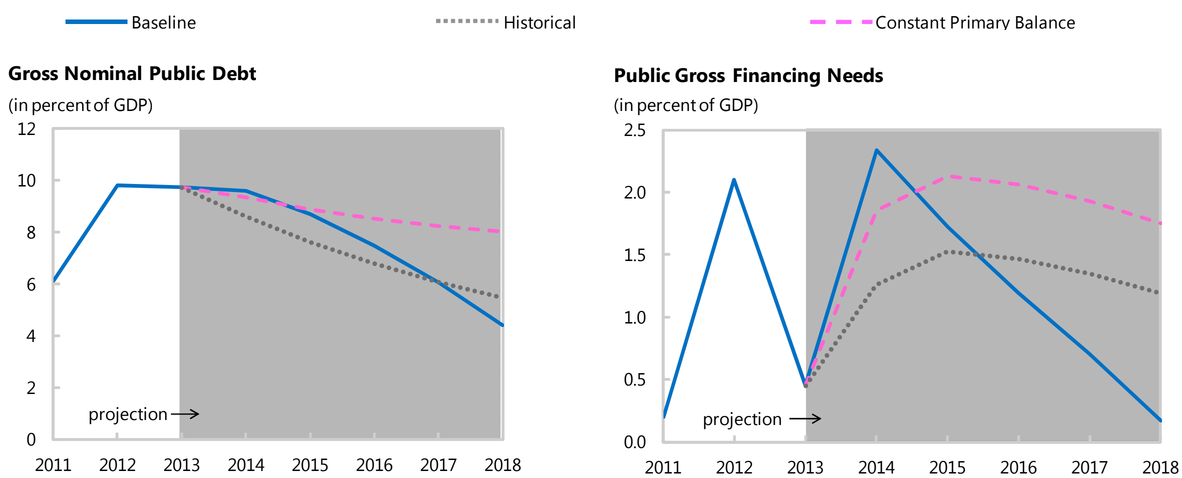
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 8. Estonia: Public DSA – Composition of Public Debt and Alternative Scenarios

Composition of Public Debt



Alternative Scenarios



Underlying Assumptions
(in percent)

Baseline Scenario	2013	2014	2015	2016	2017	2018
Real GDP growth	0.8	2.4	3.2	3.5	3.6	3.7
Inflation	5.0	4.1	4.7	4.4	4.3	4.1
Primary Balance	-0.2	-0.4	0.2	0.6	0.9	1.2
Effective interest rate	0.1	1.5	1.6	1.8	2.0	2.5
Constant Primary Balance Scenario						
Real GDP growth	0.8	2.4	3.2	3.5	3.6	3.7
Inflation	5.0	4.1	4.7	4.4	4.3	4.1
Primary Balance	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Effective interest rate	0.1	1.6	2.2	2.8	3.4	4.0

Historical Scenario	2013	2014	2015	2016	2017	2018
Real GDP growth	0.8	3.8	3.8	3.8	3.8	3.8
Inflation	5.0	4.1	4.7	4.4	4.3	4.1
Primary Balance	-0.2	0.4	0.4	0.4	0.4	0.4
Effective interest rate	0.1	1.6	2.5	3.6	4.8	6.2

Source: IMF staff.

Table 1. Estonia: Selected Macroeconomic and Social Indicators, 2008–15

(Units as indicated)

	2008	2009	2010	2011	2012	2013	2014	2015
						Est.	Proj.	
National income, prices and wages								
GDP (billions of Euro)	16.2	14.0	14.4	16.2	17.4	18.4	19.6	21.2
Real GDP growth (year-on-year in percent)	-4.2	-14.1	2.6	9.6	3.9	0.8	2.4	3.2
Average HICP (year-on-year change in percent)	10.6	0.2	2.7	5.1	4.2	3.5	3.2	2.8
GDP deflator (year-on-year change in percent)	5.4	0.2	0.3	3.0	3.3	5.0	4.1	4.7
Average monthly wage (year-on-year growth in percent)	11.8	-3.4	-4.6	4.4	6.9	7.6	6.0	6.5
Unemployment rate (ILO definition, percent, pa)	5.5	13.5	16.7	12.3	10.0	8.6	8.5	8.4
Average nominal ULC (year-on-year growth in percent)	17.1	14.0	-7.0	-5.0	2.7	6.8	3.4	3.1
Saving-investment balances (percent of GDP)								
National saving	21.2	21.9	22.3	25.9	25.3	25.4	24.8	25.1
Private	18.8	19.0	19.7	21.9	20.2	21.4	21.1	20.8
General government	2.4	2.9	2.6	4.0	5.1	4.0	3.8	4.4
Domestic investment	30.0	18.7	19.7	26.8	28.2	26.9	27.2	27.7
O/w: Fixed investment	30.3	21.2	19.0	23.6	25.2	25.3	25.7	26.2
Private	24.8	16.0	15.1	19.5	19.7	20.9	21.6	22.1
General government	5.5	5.2	3.9	4.2	5.5	4.4	4.2	4.2
Foreign saving 1/	8.7	-3.1	-2.5	0.9	2.9	1.5	2.4	2.5
General government (ESA95 basis; percent of GDP)								
Revenue	36.7	42.8	40.7	38.8	39.2	38.1	38.0	37.8
Expenditure	39.7	44.8	40.6	37.6	39.5	38.3	38.4	37.6
Financial surplus (+) / deficit (-)	-2.9	-2.0	0.2	1.2	-0.2	-0.2	-0.4	0.2
External sector (percent of GDP)								
Trade balance	-12.6	-5.0	-1.9	-2.0	-4.5	-4.7	-4.3	-4.9
Service balance	8.1	10.1	9.3	8.2	7.0	6.7	6.0	6.3
Income balance	-5.4	-3.6	-6.2	-5.9	-5.7	-3.8	-3.7	-3.5
Current account	-9.2	2.7	2.8	1.8	-1.8	-1.0	-1.3	-1.5
Gross external debt/GDP (percent) 2/	117.5	123.5	114.9	94.5	96.1	87.9	83.4	78.0
Net external debt/GDP (percent) 3/	37.7	34.2	23.5	5.1	-1.4	-6.7	-6.3	-5.6
General government external debt/GDP (percent)								
Excluding government assets held abroad	3.3	5.4	5.4	3.2	7.4	7.8	7.3	6.7
Including government assets held abroad 4/	-4.7	-3.2	-3.1	-3.6	-1.1	-0.3	-0.3	-0.3
Exchange rate (EEK/US$; euro/US$ - period averages) 5/	10.7	11.3	11.8	1.39	1.28	1.33	...	...
Real effective exchange rate (Annual changes in percent)	6.8	1.1	-1.9	1.3	-0.5	2.7	...	...
Nominal effective exchange rate (Annual changes in percent)	1.2	2.1	-3.0	-0.3	-2.0	1.6	...	...
Money and credit (year-on-year growth in percent)								
Credit to the economy 6/	6.6	-5.0	-5.2	-3.3	0.0	4.8	...	...
Broad money 7/	3.2	-0.3	2.8	30.9	5.7	6.3	...	...

Social Indicators (reference year):
Population (2012): 1.34 million; Per capita GDP (2012): €12,753; Life expectancy at birth (2012): 81.1 (female) and 71.2 (male);
Poverty rate (share of the population below the established risk-of-poverty line, 2009): 23.4 percent; Main exports: machinery and appliances.

Sources: Estonian authorities; Eurostat; and IMF staff estimates and projections.
1/ the difference with the current account reflect differences in external trade data between the national accounts (Statistical Office) and the BOP (Central Bank).
2/ Includes trade credits.
3/ Net of portfolio assets (including money market instruments), financial derivative assets, other investment assets, and reserve assets held by Estonian residents.
4/ Includes the Stabilization Reserve Fund (SRF).
5/ The Estonian kroon was pegged at 15.6466 kroons to the euro. Estonia adopted the euro on January 1, 2011.
6/ Domestic credit to nongovernment euro area resident sectors beginninhg in 2011.
7/ Beginning in 2011 data are for contributions to euro area M2 aggregate.

Table 2. Estonia: Summary of General Government Operations, 2008–15

(Percent of GDP)

	2008	2009	2010	2011	2012	2013 Est.	2014 Proj.	2015 Proj.
Revenue and Grants	36.7	42.8	40.7	38.8	39.2	38.1	38.0	37.8
Revenue	35.4	40.0	38.0	35.8	36.0	35.7	35.7	35.6
Tax revenue	19.9	22.0	20.6	20.1	20.7	20.8	21.0	21.1
Direct taxes	7.9	7.5	6.8	6.5	6.8	7.4	7.4	7.4
Personal income tax	6.2	5.6	5.4	5.2	5.3	5.6	5.7	5.7
Corporate profits tax	1.6	1.8	1.3	1.2	1.4	1.8	1.7	1.7
Indirect taxes	12.0	14.5	13.9	13.6	13.9	13.4	13.6	13.7
VAT	7.8	8.6	8.6	8.3	8.5	8.3	8.6	8.7
Excises	3.3	5.0	4.3	4.4	4.5	4.3	4.3	4.2
Other taxes (incl. land tax)	0.9	1.0	1.0	1.0	0.8	0.8	0.8	0.8
Social contributions	11.8	13.2	13.2	12.1	11.6	11.4	11.4	11.2
Pension insurance (net)	6.5	7.1	7.0	6.2	5.8	5.8	5.8	5.7
Health insurance	4.7	5.0	4.7	4.4	4.4	4.5	4.4	4.4
Unemployment insurance tax	0.3	0.8	1.2	1.2	1.2	0.9	0.9	0.9
Other (incl. self employed)	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Nontax revenue	3.7	4.8	4.1	3.7	3.7	3.4	3.3	3.3
O/w: interest income	0.6	0.4	0.3	0.2	0.2	0.1	0.1	0.1
Grants	1.4	2.9	2.8	3.0	3.2	2.5	2.3	2.2
O/w EU	0.9	2.5	2.4	2.6	2.8	2.1	2.0	1.9
Expenditure	39.7	44.8	40.6	37.6	39.5	38.3	38.4	37.6
Expense (current expenditure)	34.3	39.9	38.2	34.9	34.1	34.2	34.2	33.4
Compensation of employees	11.3	12.7	11.9	10.9	10.5	10.7	10.6	10.3
Wages and salaries	8.2	8.9	8.2	7.6	7.4	7.5	7.4	7.2
Employers' social contributions	3.1	3.8	3.6	3.3	3.1	3.2	3.1	3.1
Other goods and services	7.1	7.6	7.6	7.1	7.2	7.2	7.2	7.2
Transfers and subsidies	16.0	19.6	18.8	16.8	16.3	16.3	16.4	16.0
Subsidies	1.0	1.0	1.1	1.1	0.9	1.0	0.9	0.9
Transfers to households	12.1	15.8	14.8	13.2	12.8	12.7	12.8	12.4
Social benefits	10.5	13.9	13.0	11.5	11.0	10.9	10.8	10.7
Social transfers in kind	1.6	1.9	1.8	1.7	1.8	1.8	2.0	1.7
Other transfers	2.9	2.8	2.8	2.5	2.6	2.6	2.7	2.7
Property income	0.2	0.2	0.1	0.1	0.2	0.1	0.1	0.1
O/w: Interest	0.2	0.2	0.1	0.1	0.2	0.1	0.1	0.1
International cooperatioon	1.4	1.9	1.7	1.6	1.6	1.6	1.7	1.7
Capital transfers	1.2	0.8	1.0	0.8	0.9	0.8	0.8	0.8
Net acquisition of NFA (capital expenditure)	5.4	4.9	2.4	2.8	5.4	4.2	4.2	4.2
Acquisition	5.5	5.2	3.9	4.2	5.5	4.4	…	…
Disposal	-0.1	-0.4	-1.5	-1.4	-0.1	-0.2	…	…
Financial surplus (+) / deficit (-)	-2.9	-2.0	0.2	1.2	-0.2	-0.2	-0.4	0.2
Financing (accrual basis)	3.0	2.0	-0.3	-1.1	-0.8	0.4	0.4	-0.2
Net incurrence of liabilities	1.3	2.7	0.2	-1.1	4.2	1.1	0.8	0.1
Securities	0.3	0.5	0.0	0.1	0.0	0.0	0.0	0.0
Financial derivatives	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans	0.6	1.3	-0.3	0.0	4.2	0.7	0.8	0.1
Other financial liabilities	0.4	0.9	0.5	-1.3	0.0	0.4	0.0	0.0
Net acquisition of financial assets	-1.7	0.6	0.5	-0.1	5.0	0.7	0.4	0.3
Currency and deposits	0.1	2.5	-1.0	0.3	0.8	0.8	0.0	0.0
Securities	-2.0	-1.0	0.0	-1.3	0.0	-1.0	0.0	0.0
Shares and other equity	0.0	-1.4	1.1	0.3	4.2	1.0	0.0	0.0
Loans	0.0	0.5	-0.1	0.0	2.0	0.7	0.0	0.0
Shares and other equity	0.0	-1.9	1.2	0.3	2.2	0.2	0.0	0.0
Other financial assets	0.2	0.6	0.3	0.6	0.1	0.0	0.0	0.0
Errors and Omissions	0.0	0.1	-0.1	0.1	-1.1	0.2	0.0	0.0
Memorandum items:								
GDP (millions of Euro)	16,235	13,970	14,371	16,216	17,415	18,435	19,650	21,235
General Government borrowing	0.9	1.8	-0.2	0.1	4.2	0.7	0.8	0.1
General Government debt (gross)	4.5	7.1	6.7	6.1	9.8	10.0	10.2	9.5
General Government debt (net)	-5.7	-6.9	-5.6	-3.8	-0.3	0.7	1.6	1.4

Sources: Eurostat; Statistics Estonia; and IMF staff calculations.

Table 3. Estonia: General Government Financial Assets and Liabilities, 2008–13

(Millions of Euros)

	2008	2009	2010	2011	2012	2013 Sept.
Total Assets	**5,526**	**5,754**	**6,929**	**7,244**	**8,122**	**8,339**
Fiscal reserves	1,669	1,952	1,765	1,618	1,756	1,953
Currency and deposits	588	1,015	831	905	1,049	1,354
Securities other than shares, excl. financial derivatives	1,079	937	934	712	708	599
Short-term securities, excl. financial derivatives	300	397	389	203	287	189
Long-term securities, excl. financial derivatives	779	540	544	510	421	410
Financial derivatives	2	1	0	0	0	0
Loans	158	196	247	255	597	713
Short-term	11	11	9	10	9	5
Long-term	147	186	238	245	588	709
Shares and other equity	2,955	2,778	4,063	4,464	4,845	4,875
O/w: Quoted shares	192	72	55	44	64	72
Other accounts receivable/ payable	744	827	854	908	924	798
Total Liabilities 1/	**13,780**	**1,797**	**1,843**	**1,636**	**2,370**	**2,645**
Securities other than shares, excl. financial derivatives	1,720	239	241	253	247	247
O/W: Long-term securities, excl. financial derivatives	1,720	235	241	253	247	247
Loans	5,680	754	723	731	1,468	1,569
Short-term	90	10	6	7	10	14
Long-term	5,590	744	717	724	1,459	1,555
Other accounts receivable/ payable	6,380	803	879	652	655	829

Source: Eesti Pank.

1/ Including commitments under the European Financial Stability Fund.

Table 4. Estonia: Summary Balance of Payments, 2008–15

(Units as indicated)

	2008	2009	2010	2011	2012	2013	2014	2015
						Est.	Proj.	
				(Millions of Euro)				
Current Account	-1,486	383	409	291	-310	-184	-261	-327
Primary Current Account 1/	-602	888	1,302	1,248	676	514	458	415
Trade Balance	-2,041	-697	-271	-328	-776	-858	-847	-1,030
Exports	8,490	6,354	8,769	12,050	12,587	12,255	13,163	14,029
Of which : goods for processing	1,208	1,162	1,461	2,332	1,729	1,067	1,181	1,281
Imports	-10,531	-7,051	-9,040	-12,378	-13,363	-13,113	-14,010	-15,059
Of which : goods for processing	-1,340	-1,113	-1,230	-1,863	-1,469	-836	-921	-1,008
Services Balance	1,315	1,409	1,339	1,322	1,214	1,226	1,174	1,333
Receipts	3,601	3,219	3,441	3,987	4,256	4,475	4,679	4,997
of which: travel and tourism	808	780	809	897	954	1,049	1,096	1,171
Payments	-2,286	-1,810	-2,102	-2,665	-3,043	-3,249	-3,505	-3,664
Income	-884	-506	-893	-956	-987	-698	-719	-741
Current Transfers	123	176	233	254	239	146	131	112
Capital and Financial Account	1,439	-455	-356	-373	315	-30	-135	-124
Capital Transfers	212	486	505	669	606	504	421	433
Financial Account	1,227	-941	-861	-1,042	-292	-534	-556	-557
Direct Investment	422	211	1,100	1,290	440	447	220	250
From abroad	1,182	1,325	1,207	245	1,180	715	502	547
Outward (by Estonians)	-760	-1,114	-107	1,045	-741	-269	-282	-296
Net equity investment	506	-1,452	-462	1,152	-112	-112	-304	-312
Loans and other investments 2/	908	267	-2,263	-3,549	-562	-458	-472	-495
Of which:								
Trade credits (net)	-90	-159	-6	-16	-178	-182	…	…
Banks (net)	838	416	-1,636	-2,520	-98	-522	…	…
Monetary authorities	-111	7	7	-294	-1,099	443	…	…
Other	271	3	-628	-718	812	-197	…	…
Errors and Omissions	47	73	-53	81	-5	214	0	0
Memorandum Items:				(Percent of GDP, unless otherwise specified)				
Current Account	-9.2	2.7	2.8	1.8	-1.8	-1.0	-1.3	-1.5
Trade balance	-12.6	-5.0	-1.9	-2.0	-4.5	-4.7	-4.3	-4.9
Service balance	8.1	10.1	9.3	8.2	7.0	6.7	6.0	6.3
Income balance	-5.4	-3.6	-6.2	-5.9	-5.7	-3.8	-3.7	-3.5
Compensation of employees, net	0.9	0.9	0.9	1.2	1.2	1.2	1.2	1.1
Reinvested earnings, net	-4.5	-2.2	-5.7	-4.7	-5.9	-4.2	-5.0	-4.7
Other income, net	-1.8	-2.3	-1.4	-2.3	-0.9	-0.8	0.2	0.0
Current transfers	0.8	1.3	1.6	1.6	1.4	0.8	0.7	0.5
Capital and financial Account	8.9	-3.3	-2.5	-2.3	1.8	-0.2	-0.7	-0.6
Exports of goods and services (growth in percent)	5.9	-20.8	27.5	31.3	5.0	-0.7	6.6	6.6
Imports of goods and services (growth in percent)	-1.6	-30.9	25.7	35.0	9.1	-0.3	7.1	6.9
Net FDI	2.6	1.5	7.7	8.0	2.5	2.4	1.1	1.2
Total external debt 7/								
Gross	117.5	123.5	114.9	94.5	96.1	87.9	83.4	78.0
Net 8/	37.7	34.2	23.5	5.1	-1.4	-6.7	-6.3	-5.6
NIIP	-76.7	-80.6	-72.4	-56.4	-54.0	-45.2	…	…
General government external debt 9/								
Excluding Govt. assets held abroad	3.3	5.4	5.4	3.2	7.4	7.8	7.3	6.7
Including Govt. assets held abroad	-4.7	-3.2	-3.1	-3.6	-1.1	-0.3	-0.3	-0.3
Debt Service/Exports of GNFS (percent)	87.3	147.6	106.1	77.8	63.9	64.5	57.4	54.4

Sources: Bank of Estonia; and IMF staff estimates and projections.

1/ Excluding interest payments and reinvested earnings.
2/ Includes operations in debt securities.
3/ Excludes Government deposits held abroad (including in the SRF).
4/ Changes in gross international reserves may differ from flows implied by overall balance of payments due to valuation changes.
5/ Includes trade credits.
6/ Short term debt is defined on the basis of original maturity.
7/ Starting in 2000, the definition of external debt was widened to include money market instruments and financial derivatives.
8/ Net of portfolio assets (including money market instruments), financial derivative assets, other investment assets, and reserve assets held by Estonian residents.
9/ Includes government guaranteed debt.

Table 5. Estonia: Macroeconomic Framework, 2008–19

(Percent of GDP, unless otherwise indicated)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
						Est.			Projections			
GDP real growth (percent)	-4.2	-14.1	2.6	9.6	3.9	0.8	2.4	3.2	3.5	3.6	3.7	3.7
Contribution to real GDP growth (percent)												
Consumption 1/	-2.0	-8.6	-1.6	2.3	3.2	2.4	2.7	2.7	2.6	2.5	2.5	2.5
Investment 2/	-8.2	-13.0	1.5	8.9	2.0	-0.9	1.1	1.1	1.2	1.3	1.8	1.9
Exports (goods and services)	0.7	-15.1	15.1	18.5	5.1	1.6	4.2	4.2	4.2	4.1	4.1	4.0
Imports (goods and services)	-5.3	-23.3	12.3	20.5	7.8	2.3	5.2	4.5	4.5	4.3	4.6	4.5
Gross saving	21.2	21.9	22.3	25.9	25.3	25.4	24.8	25.1	25.9	26.7	27.7	29.0
Private	18.8	19.0	19.7	21.9	20.2	21.4	21.1	20.8	21.0	21.5	22.1	23.0
Public	2.4	2.9	2.6	4.0	5.1	4.0	3.8	4.4	4.9	5.3	5.6	6.0
Investment	30.0	18.7	19.7	26.8	28.2	26.9	27.2	27.7	28.2	28.5	29.1	29.8
O/w: Fixed investment	30.3	21.2	19.0	23.6	25.2	25.3	25.7	26.2	26.8	27.1	27.8	28.5
Private	24.8	16.0	15.1	19.5	19.7	20.9	21.6	22.1	22.5	22.7	23.3	23.8
Public	5.5	5.2	3.9	4.2	5.5	4.4	4.2	4.2	4.3	4.4	4.5	4.7
Foreign saving	8.7	-3.1	-2.5	0.9	2.9	1.5	2.4	2.5	2.3	1.8	1.4	0.8
Memorandum items:												
Fiscal balance 3/	-2.9	-2.0	0.2	1.2	-0.2	-0.2	-0.4	0.2	0.6	0.9	1.1	1.3
Revenues	36.7	42.8	40.7	38.8	39.2	38.1	38.0	37.8	37.4	36.8	36.3	35.9
Expenditure	39.7	44.8	40.6	37.6	39.5	38.3	38.4	37.6	36.8	36.0	35.2	34.7
Structural balance	-5.1	0.4	1.0	0.3	0.9	0.8	0.7	0.9	1.0	1.2	1.3	1.3
Total general government debt	4.5	7.1	6.7	6.1	9.8	10.0	10.2	9.5	8.5	7.3	5.9	4.5
Net non-debt creating capital inflows ("+" inf	4.2	4.0	9.3	12.2	4.4	3.7	1.9	1.9	1.9	2.0	1.9	1.9
Capital transfers 4/	1.3	3.5	3.5	4.1	3.5	2.7	2.1	2.0	1.9	1.9	1.8	1.7
Net equity investment	0.3	-1.0	-1.9	0.1	-1.6	-1.5	-1.4	-1.3	-1.3	-1.2	-1.2	-1.1
Net foreign direct investment	2.6	1.5	7.7	8.0	2.5	2.4	1.1	1.2	1.2	1.3	1.3	1.3
HICP inflation (average, in percent)	10.6	0.2	2.7	5.1	4.2	3.5	3.2	2.8	2.5	2.4	2.3	2.2
Unemployment rate (percent)	5.5	13.5	16.7	12.3	10.0	8.6	8.5	8.4	8.2	8.1	8.0	8.0
Average wage growth (percent)	11.8	-3.4	-4.6	4.4	6.9	7.6	6.0	6.5	6.0	5.5	5.5	5.5
Labor compensation share of GDP	50.7	51.2	48.4	46.1	46.3	47.5	47.1	46.4	45.5	44.3	43.3	42.4
Output gap (in percent of potential output)	6.3	-9.1	-8.5	-1.8	-0.6	-1.8	-1.2	-0.7	-0.4	-0.2	0.0	0.0
Growth rate of potential output (in percent)	0.7	0.4	2.0	2.1	2.6	2.0	1.8	3.1	3.2	3.6	3.4	3.7

Sources: Estonian authorities; and IMF staff estimates and projections.

1/ Includes government, private and nonpublic institutions serving households.
2/ Includes private and public capital formation, changes in inventories, and statistical discrepancy.
3/ Cash basis. Public savings minus public investment differs from the fiscal balance by the amount of capital transfers received from abroad.
4/ Mainly EU capital grants, all of which are channelled through the budget.

Table 6. Estonia: Indicators of Economic Vulnerabilities, 2008–13

(Percent of GDP, unless otherwise indicated)

	2008	2009	2010	2011	2012	2013
Financial indicators						
Public sector external debt 1/	3.3	5.4	5.4	3.2	7.4	7.8
Private sector credit (year-on-year, percent) 2/	6.6	-5.0	-5.2	-3.3	0.0	4.8
External Indicators						
Exports of goods and services (year-on-year, percent)	5.9	-20.8	27.5	31.3	5.0	-0.7
Imports of goods and services (year-on-year, percent)	-1.6	-30.9	25.7	35.0	9.1	-0.3
Current account balance	-9.2	2.7	2.8	1.8	-1.8	-1.0
Capital and financial account balance	8.9	-3.3	-2.5	-2.3	1.8	-0.2
Total external debt 3/	117	124	115	95	96	88
of which: Public sector debt 1/	3.3	5.4	5.4	3.2	7.4	7.8
Net external debt 4/	37.7	34.2	23.5	5.1	-1.4	-6.7
Debt service to exports of GNFS	87.3	147.6	106.1	77.8	63.9	64.5
External interest payments to exports of GNFS (percent)	17.4	12.0	6.6	4.5	1.4	1.2
External Amortization payments to exports of GNFS (percent)	69.9	135.7	99.6	73.3	62.5	63.3
Exchange rate (per US$, period average) 5/	10.7	11.3	11.8	1.39	1.28	1.33
Financial Market Indicators						
Stock market index 6/	274	405	698	531	734	818
Foreign currency debt rating 7/	A	A-	A	AA-	AA-	AA-
Money market spread 8/	4.10	2.35	0.11	n.a.	n.a.	n.a.
Spread of benchmark bonds (basis points, end of period) 8/						

Sources: Estonian authorities; Bloomberg; Standard & Poor's; and IMF staff estimates.

1/ Total general government and government-guaranteed debt excluding government assets held abroad.
2/ Credit to households and nonfinancial institutions.
3/ External debt includes money market instruments and financial derivatives.
4/ Net of portfolio assets (including money market instruments), financial derivative assets, other investment assets, and reserve assets held by residen
5/ For 2008-10, EEKs per US$; starting in 2011, Euros per US$.
6/ Tallinn stock exchange index (OMX Tallinn), end of period.
7/ Standard & Poor's long-term foreign exchange sovereign rating.
8/ One-month spread between Tallinn interbank borrowing rate (TALIBOR) and the corresponding EURIBOR rate.

Table 7. Estonia: Households' Financial Assets and Liabilities, 2008–12

(Millions of Euros)

	2008	2009	2010	2011	2012
Total Assets	**17,878**	**18,494**	**15,656**	**13,354**	**13,882**
Currency and deposits	3,599	4,172	4,111	4,635	5,285
Securities other than shares	40	107	27	30	26
Shares and other equity	12,392	12,031	9,171	6,237	5,646
Insurance technical reserves	1,061	1,445	1,679	1,687	2,003
Other	787	740	668	766	924
Total Liabilities	**9,304**	**8,946**	**8,893**	**7,933**	**7,803**
Loans	8,048	7,774	7,508	7,338	7,257
Short-term	142	138	150	126	146
Long-term	7,906	7,636	7,358	7,212	7,111
Shares and other equity	702	597	810	0	0
Other	554	576	576	596	546
Net Financial Assets	**8,574**	**9,548**	**6,762**	**5,421**	**6,079**
Memorandum item					
Total liabilities as a ratio of total gross wages and salaries	149.5	167.8	171.5	141.9	129.2

Source: Statistics Estonia

INTERNATIONAL MONETARY FUND

REPUBLIC OF ESTONIA

April 11, 2014

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By	European Department

CONTENTS

FUND RELATIONS

(As of February 28, 2014)

Membership Status: Joined: May 26, 1992; Article VIII

General Resources Account

	SDR Million	Percent Quota
Quota	93.9	100.00
Fund holdings of currency	79.72	84.90
Reserve Tranche Position	14.18	15.10

SDR Department

	SDR Million	Percent Allocation
Net cumulative allocation	61.97	100.00
Holdings	62.04	100.12

Outstanding Purchases and Loans: None

Latest Financial Arrangements

In millions of SDR, (mm/dd/yyyy)

Type	Approval Date	Expiration Date	Amount Approved	Amount Drawn
Stand-by	03/01/2000	08/31/2001	29.34	0.00
Stand-By	12/17/1997	03/16/1999	16.10	0.00
EFF	07/29/1996	08/28/1997	13.95	0.00

Projected Payments to Fund: None

Implementation of HIPC Initiative: Not applicable.

Implementation of MDRI Assistance: Not applicable.

Implementation of PCDR Assistance: Not applicable.

Exchange Arrangements: As of January 1, 2011, Estonia's currency is the euro, which floats freely and independently against other currencies.

Estonia has accepted the obligations under Article VIII, Sections 2(a), 3 and 4 of the Fund's Articles of Agreement, and maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions, except for those measures imposed for security reasons in accordance with Regulations of the Council of the European Union, as notified to the Executive Board in accordance with Decision No. 144-(52/51). An updated and comprehensive list of all EU restrictions can be found at:
http://ec.europa.eu/external_relations/cfsp/sanctions/measures.htm

Article IV Consultation: Estonia is on the 12-month consultation cycle. The last Article IV consultation was concluded on May 3, 2013. The Executive Board assessment is available at http://www.imf.org/exernal/country/EST/

FSAP Participation and ROSCs: A review under the Financial Sector Assessment Program (FSAP) was completed at the time of the 2000 Article IV Consultation. Further Reports on Observance of Standards and Codes (ROSC) modules were discussed in the 2001 Article IV Consultations and updated during the 2002 Consultation. A FAD mission concluded a fiscal transparency ROSC in January 2009 and an FSAP update was completed in February 2009. MONEYVAL conducted its evaluation of Estonia's AML/CFT framework in February 2008, and its report was adopted in December 2008.

Technical Assistance: The following table summarizes the technical assistance missions provided by the Fund to Estonia since 2000.

Resident Representative: James Roaf (stationed in Warsaw, Poland).

Republic of Estonia: Technical Assistance from the Fund, 2000–13

Department	Issue	Action	Date	Counterpart
FAD	Pension reform	Mission	April 2000	Ministries of Finance and Social Affairs
MAE	Banking Supervision	Staff Visit	December 2000	Bank of Estonia
FAD	Tax Policy	Mission	March 2001	Ministry of Finance
INS	Financial Markets	Training	September 2002	Bank of Estonia
FAD	Medium-term Budget	Technical Assistance	December 2003	Ministry of Finance
FAD	Tax Reform	Technical Assistance	February 2005	Ministry of Finance
FAD	Revenue Administration	Technical Assistance	December 2013	Ministry of Finance

STATISTICAL ISSUES

General: Estonia's data provision to the Fund is adequate for surveillance purposes. A May 2001 data ROSC mission found that the quality of macroeconomic statistics was generally good. The 2009 fiscal transparency ROSC indicated that Estonia now meets nearly all of the requirements of the transparency code, and approached best international practice in some areas. Estonia subscribed to the SDDS on September 30, 1998, with metadata posted on the DSSB on January 27, 1999, and met SDDS specifications on March 30, 2000. The latest (2010) annual observance report for Estonia for the SDDS was posted on the Fund's website in May 2011. (http://dsbb.imf.org/images/pdfs/AnnualReports/2010/EST_SDDS_AR2010.pdf) (SDDS webpage for EST) http://dsbb.imf.org/Pages/SDDS/CtyCtgList.aspx?ctycode=EST

National Accounts: The national accounts are compiled by Statistics Estonia (SE) in accordance with the guidelines of the European System of Accounts 1995 (ESA 95). Quarterly GDP estimates at current and at constant prices are compiled using the production, income and expenditure approaches and statistical discrepancies among them have at times been sizable. The annual and the quarterly national accounts are compiled at previous year prices and chain-linked to 2005. As of September 2011, data are compiled on the basis of the new version of classification of activities EMTAK 2008, and using double deflation. National accounts for the first quarter 2009 to first quarter 2013 were revised in September 2013. National accounts data for 2013 are at odds with other data that suggest somewhat higher real growth and lower inflation than the reported GDP deflator, which might suggest measurement problems.

Public Finance: Fiscal data are published by the Ministry of Finance (MoF), while historical data are also available on Statistics Estonia's website. Monthly central government data are disseminated with a lag of up to 25 days after the end of the month. Quarterly data on foreign loans and guarantees by the central government are published in Estonian with a monthly lag. The Ministry is using one of its two allowed SDDS flexibility options on the timeliness of monthly central government operations data, and disseminate these data on the National Summary Data page. Comprehensive annual data on central and general government operations (accrual basis) are reported in the *GFS Yearbook*. These data include a statement of operations and the government balance sheet, including data on financial assets and liabilities, both domestic and foreign. Quarterly data for the general government are included in the *International Finance Statistics*.

Monetary and Financial Statistics: The Bank of Estonia (BoE) compiles and reports monetary and financial statistics consistent with the IMF's *Monetary and Financial Statistics Manual.* Aggregate financial data are compiled by the BoE and reported on a monthly basis. The majority of statistics are disseminated on the Bank of Estonia's webpage on the 17th banking day after the end of the reporting period. Data for individual banks are also available on a quarterly basis since 2008Q1 on the Financial Supervision Authority's webpage. Estonia also regularly provides requested Financial Soundness Indicators.

External Sector: Quarterly balance of payments, external debt, and international investment position (IIP) data are compiled by the BoE consistent with the *Balance of Payments Manual* fifth edition (BMP5). Daily exchange rate data are available with a one working day lag. Monthly import/export data are available with a two month lag. The Data Template on International Reserves and Foreign Currency Liquidity is disseminated monthly according to the operational guidelines and is hyperlinked to the Fund's DSBB.

Dissemination of Statistics: The Estonian authorities disseminate a range of economic statistics, with a significant amount of data are available on the Internet:

- metadata for data categories defined by the Special Data Dissemination Standard are posted on the IMF's DSBB (http://dsbb.imf.org);
- the Bank of Estonia website (http://www.eestipank.info/frontpage/en/)provides data on monetary statistics, balance of payments, IIP, external debt and other main economic indicators;
- the Statistics Estonia website (http://www.stat.ee/en) provides information on economic and social development indicators;
- the Ministry of Finance homepage (http://www.fin.ee/?lang=ee) includes information on the government's annual multi-year State Budget Strategy, as well as information and data on the national budget, and government finance statistics (deficit, debt, financial assets).

Republic of Estonia: Table of Common Indicators Required for Surveillance

As of March 31, 2014

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]	Memo Items: Data Quality – Methodological soundness[7]	Memo Items: Data Quality – Accuracy and reliability[8]
Exchange Rates	March 30, 2014	March 31, 2014	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	February 2014	March 2014	M	M	M		
Reserve/Base Money	February 2014	March 2014	M	M	M	O, LO, LO, LO	O, O, O, NA
Broad Money	February 2014	March 2014	M	M	M		
Central Bank Balance Sheet	February 2014	March 2014	M	M	M		
Consolidated Balance Sheet of the Banking System	February 2014	March 2014	M	M	M		
Interest Rates[2]	February 2014	March 2014	M	M	M		
Consumer Price Index	February 2014	March 2014	M	M	M	O, O, O, O	LO, LO, O, LO
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q4/2013	March 2014	Q	Q	Q	LO, LO, O, O	LO, LO, O, NO
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	February 2014	March 2014	M	M	M		
Stocks of Central Government and Centarl Government-Guaranteed Debt[5]	Q4/2013	March 2014	Q	Q	Q		
External Current Account Balance	Q4/2013	March 2014	Q	Q	Q	O, O, LO, O	O, O, O, O, O
Exports and Imports of Goods and Services	January 2014	March 2014	M	M	M		
GDP/GNP	Q4/2013	March 2014	Q	Q	Q	O, O, O, LO	LO, LO, LO, LNO
Gross External Debt	Q4/2013	March, 2014	Q	Q	Q		
International Investment Position[9]	Q4/2013	March 2014	Q	Q	Q		

[1] Any reserve assets that are pledged of otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Not Available (NA).
[7] Reflects the assessment provided in the data ROSC published on November 6, 2001, and based on the findings of the respective missions that took place during May 10–18, 2001 for the dataset corresponding to the variable in each row. For fiscal data, also takes account of the 2009 Fiscal Transparency ROSC. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).
[8] Same as footnote 7, except referring to international standards concerning (respectively) source data, statistical techniques, assessment and validation, and revision studies.
[9] Includes external gross financial asset and liability positions vis-à-vis nonresidents.

INTERNATIONAL MONETARY FUND
COMMUNICATIONS DEPARTMENT

Press Release No. 14/204
FOR IMMEDIATE RELEASE
May 8, 2014

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2014 Article IV Consultation with the Republic of Estonia

On May 05, 2014, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with the Republic of Estonia.

In 2013, Estonia's recovery from the crisis continued but at a slower pace. Real GDP growth was 0.8 percent, with private consumption providing the main support while net exports made a negative contribution. Inflation declined to about 3½ percent, but stayed above the euro average. Public finances remained strong, with a fiscal deficit of 0.2 percent of GDP, a gross public debt of 10 percent of GDP, and a net public debt near zero. Unemployment continued to fall, bringing the unemployment rate down to 8.6 percent, about half the 2010 peak. Nominal wage growth accelerated, outstripping productivity growth and putting pressure on price competitiveness. The current account deficit was small, and the net international investment position improved. Gross external debt fell sharply in 2013 and net external debt of the economy turned negative.

Economic activity should pick up in 2014 and the medium-term, supported by both external and domestic demand. Real GDP growth is projected at 2.4 percent in 2014, rising toward expected potential growth of 3 to 3.5 percent in the medium term. The downward trend in inflation is expected to continue toward 2 percent over the medium term, but could be slowed by increased wage pressure. Risks to the outlook are tilted moderately toward the downside and mostly relate to trade. In particular, less favorable than projected economic conditions in the Nordic Baltic region and the CIS could slow Estonia's growth through lower exports or FDI. Also, a rise in interest rates from a shock in the Nordic banking system could adversely affect Estonia. Finally, labor market overheating could also undercut competitiveness and export growth.

Estonia's policy agenda is characterized by continuity in policies. With a projected fiscal deficit of 0.4 percent of GDP in 2014, the fiscal stance will remain appropriate given cyclical conditions. Over the medium term, the authorities' structural surplus targets will keep the government's balance sheet strong and allow automatic stabilizers to operate fully in case of

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[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.

downturns. However, the government should refrain from additional large wage hikes which could have demonstration effects. In the financial sector, the envisaged early implementation of the new capital and liquidity provisions under Basel III will further enhance Estonia's financial stability. Also, a close collaboration with the ECB and the Nordic -Baltic supervisory structures will be important to smooth Estonia's transition to the Banking Union. Estonia's high level of structural unemployment needs to be addressed. In addition to the current active labor market policies to reduce skills mismatches and keep people in the labor force, lowering the tax wedge on lower-wage workers could further reduce unemployment. Finally, Estonia should coordinate with its Baltic and Nordic neighbors to diversify infrastructure, which could also boost competitiveness.

Executive Board Assessment[2]

Executive Directors commended Estonia's continued commitment to sound macroeconomic policies. Directors noted that while the outlook for growth is favorable, risks are tilted to the downside because of the difficult regional environment. They emphasized the need to maintain strong macroeconomic policies to preserve competitiveness, address the high unemployment rate, and enhance long-term growth.

Directors welcomed the 2014 budget, which continues Estonia's tradition of prudent fiscal policy characterized by low deficits or surpluses, and low debt. They considered the budget's underlying stance to be broadly appropriate and consistent with prevailing economic conditions. Directors agreed that the creation of the fiscal council and the structural surplus target embodied in the new Budget Law should help address the previous pro-cyclical patterns of fiscal policy by preventing unsustainable increases in expenditure during good times, and provide scope to allow automatic stabilizers to operate in downturns. More broadly, Directors underscored that fiscal policy should be flexible and growth friendly.

Directors welcomed the authorities' commitment to maintain a strong financial system in the face of the evolving financial architecture, including the planned early implementation of the new capital and liquidity provisions. They advised close collaboration among the Estonian authorities, the ECB, the Nordic-Baltic sector supervisory, and governmental structures to ensure that Estonia's transition to the Banking Union is smooth. In the context of a strengthened macroprudential framework, developments in housing prices should be closely monitored.

Directors emphasized the need to preserve competitiveness in light of recent increases in wages and unit labor costs. While acknowledging that wages are largely market determined, they encouraged the authorities to refrain from additional large public sector wage hikes or agree to minimum wage increases, until it is clear that the wage rates are not undercutting net exports.

[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.

Directors agreed that Estonia's high level of structural unemployment needs to be addressed. They noted that some policies to address skills mismatches and maintain labor participation rates are already in place, and that funding for these programs has been substantially expanded. Directors agreed that further efforts to improve the skills of those already working and increase the number of people with education in technical fields should reduce the shortage of highly-skilled workers and boost productivity. They also recommended reducing the tax wedge on lower-wage workers in a budget-neutral manner, which would contribute to containing unit labor costs and improving competitiveness.

Directors agreed that regionally-coordinated efforts to improve infrastructure links to Estonia's neighbors could help improve competitiveness and better connect with the rest of the European Union.

Estonia: Selected Macroeconomic and Social Indicators, 2011–14

(Units as indicated)

	2011	2012	2013	2014 Proj.
National income, prices and wages				
GDP (euro, billions)	16.2	17.4	18.4	19.6
Real GDP growth (year-on-year in percent)	9.6	3.9	0.8	2.4
Average HICP (year-on-year in percent)	5.1	4.2	3.5	3.2
GDP deflator (year-on-year in percent)	3.0	3.3	5.0	4.1
Average monthly wage (year-on-year in percent)	4.4	6.9	7.6	6.0
Unemployment rate (ILO definition, percent)	12.3	10.0	8.6	8.5
Average nominal ULC (year-on-year in percent)	-5.0	2.7	6.8	3.4
Saving-investment balance (in percent of GDP)				
National saving	25.9	25.3	25.4	24.8
Private	21.9	20.2	21.4	21.1
Public	4.0	5.1	4.0	3.8
Domestic investment	26.8	28.2	26.9	27.2
Fixed investment	23.6	25.2	25.3	25.7
Private	19.5	19.7	20.9	21.6
Public	4.2	5.5	4.4	4.2
Foreign saving	0.9	2.9	1.5	2.4
General government (ESA95 basis; percent of GDP)				
Revenue	38.8	39.2	38.1	38.0
Expenditure	37.6	39.5	38.3	38.4
Fiscal balance	1.2	-0.2	-0.2	-0.4
External sector (in percent of GDP)				
Trade balance	-2.0	-4.5	-4.7	-4.3
Service balance	8.2	7.0	6.7	6.0
Current account	1.8	-1.8	-1.0	-1.3
Gross international reserves (euro, millions)				
In months of imports	2.6	...	...	...
In percent of gross short-term debt (including trade credits)	32.7	...	...	...
In percent of base money	82.9	...	...	...
Gross external debt/GDP (in percent) 1/	94.5	96.1	87.9	83.4
Net external debt/GDP (in percent) 2/	5.1	-1.4	-6.7	-6.3
General government external debt/GDP (in percent)				
Excluding government assets held abroad	3.2	7.4	7.8	7.3
Including government assets held abroad 3/	-3.6	-1.1	-0.3	-0.3
General government external debt/GDP (gross, in percent)	6.1	9.8	10.0	10.2
General government external debt/GDP (net, in percent)	-3.8	-0.3	0.7	1.6
Exchange rate (euro/US$- period average) 4/	1.41	1.29	1.33	...
Money and credit (year-on-year growth in percent)				
Domestic credit to nongovernment sector	-3.3	0.0	4.8	...
Broad money	30.9	5.7	6.3	...

Sources: Estonian authorities; and IMF staff estimates and projections.
1/ Includes trade credits.
2/ Net of portfolio assets (including money market instruments), financial derivatives assets, other investment assets, and reserve assets held by Estonian residents.
3/ Includes the Stabilization Reserve Fund (SRF).
4/ Until 2011, the Estonian Kroon was pegged at 15.6466 kroons to the euro. The euro was adopted on January 1, 2011.

Statement by Mr. Audun Groenn, Executive Director for the Republic of Estonia and by Mr. Martin Lindpere, Advisor to the Executive Director
May 5, 2014

On behalf of the Estonian authorities we thank the IMF mission team for the candid and productive discussions and for the well-focused Article IV and Baltic cluster reports. The authorities share staff's views on the state of the Estonian economy and highly appreciate their economic policy advice.

Macroeconomic performance and outlook

The Estonian economy has weathered well the recent years' uncertain external environment. In 2011—the recovery phase—broad based economic growth reached 9.6 percent, being followed by 3.9 percent growth in the stabilization phase in 2012. In that period, the Estonian economy was pushed towards a healthier equilibrium as the imbalances continued to decline and resilience was improved. 2013 brought along a growth slowdown to 0.8 percent, being affected by economic challenges in our neighboring countries, especially in Finland and Russia, and by sector-specific adverse shocks. This has not had a substantial impact on the strong labor market performance, which is keeping consumer confidence high and supporting private consumption.

Looking forward, the latest forecast of the Ministry of Finance expects economic growth to rise to 2 percent in 2014 and to accelerate thereafter to about 3.5 percent. The corporate sector is ready for a growth take-off with the high amount of retained earnings, and a leverage ratio being at the lowest level in ten years. However, uncertainties in the external environment still weigh on investment activity. The evolving geopolitical tension has become the predominant risk for the Estonian economy, which has not yet been penciled into the baseline scenario. Estonia's competitiveness depends not only on domestic factors but also on the performance of the Nordic economies, being positioned higher in the same global supply chain. Additionally, there are concerns that a re-emergence of global financial spillovers may reach Estonia, if liquidity or financing conditions of the Nordic parent banks are affected. Though, this risk has lessened as bank lending is currently financed by deposits.

Inflation has slowed significantly since mid-2013, reaching 0.2 percent in annual terms in March, but is expected to accelerate to 1.4 percent in 2014. Restrained price developments in the external environment have successfully counterbalanced domestic pressures. A noticeable negative price impulse stems from the energy component. Inflation in Estonia is held back by temporary factors as well because there is less administrative price increases.

However, signs of tightening have appeared in the labor market, escalating wage growth and pressing prices in some segments of the consumer basket. Continued wage growth that erodes competitiveness is the main domestic risk and therefore labor costs need vigilant monitoring. Although unit labor costs have deteriorated, labor costs have not grown faster than corporate turnover, referring to other costs that have squeezed profit margins. In the past, the Estonian labor market has repeatedly shown flexibility that has supported necessary structural adjustment. The unemployment rate has declined by more than 10 percentage points from its peak in 2010 to the current 8 percent, and recent years have seen an increase in labor market activity. If the labor market participation rate had remained constant at the boom years' level, the unemployment rate would have been now at approximately 5 percent.

Although the actual unemployment rate has fallen, it is worrisome that the structural unemployment rate is relatively high. The latter cannot be measured with high precision and, as a sign of measurement uncertainty, staff's estimate of structural unemployment is somewhat higher compared to the authorities', OECD's, and European Commission's estimates. The authorities still fully agree that structural unemployment is too high and commit to continued policy action.

The assessment of wage pressures should take into account people's choice of working abroad as this is a viable option while living in Estonia, especially for some professions. The main driver of this process is declining but still substantial wage level difference. Working abroad has many positive consequences, as it fosters skills transfer and accumulation of human capital. The Estonian authorities highly appreciate the EU common labor market policy, but they would be grateful for policy advice on how to contain wage pressures from work migration.

Fiscal Policy

The Estonian authorities have given high priority to a prudent fiscal policy and the recently formed government has reaffirmed this commitment. In line with the recent amendments to budget position rules in the State Budget Act, the newly published state budget strategy aims to have at least a structural budget balance in the medium term and to achieve a small structural surplus in most years. Estonia has attained structural surpluses since 2009 and prior to the global financial crisis as well. The forecast for 2014 shows a small structural surplus of 0.1 percent of GDP. Given that high uncertainty surrounds the structural balance estimates in real time, high attention is paid on the nominal budget outcome as well. The current outlook prescribes a 0.7 percent nominal deficit for 2014, which is expected to decline over the forthcoming years. A significant part of this deficit comes from the increased payments into the second pension pillar, which were temporarily suspended in the crisis years, and the use of carbon dioxide quota sale revenues, which were received earlier. The authorities consider the fiscal policy stance appropriate at this juncture, especially against the background of a swift wage growth and a high degree of monetary accommodation on the domestic side and fiscal and financial fragilities on the external side. Both the public sector's current liquid financial assets and gross debt are at about the 10 percent level of GDP.

The Estonian government aims to maintain the tax burden at the pre-recession level of around 32 percent of GDP with the intention to reduce further labor taxes. In an EU country comparison of labor tax burden, Estonia is below average. The planned changes for 2015 include a decrease in the income tax rate from 21 to 20 percent, a reduction in unemployment insurance tax rate by 0.6 percentage points to 2.4 percent and increases in tax-free income, being compensated by increases in alcohol, tobacco, and gas excise taxes. The labor tax burden peaked at almost 37 percent level in 2010 due to the crises measures, but has declined thereafter and is expected to almost reach the 33 percent level in 2015. This is in line with staff's advice in the Baltic cluster report. Public sector capital expenditures will be almost 5 percent of GDP in 2014, but will gradually decline thereafter.

The government has reached an agreement to reduce tax exemptions and improve tax compliancy with a number of measures. The value added tax incentive will be reduced when a company's passenger car is used for private use and the preferential excise duty on fuel with special marking (except in agriculture and fishing boats) will be abolished. The introduction of the Annex to the VAT declaration for recording larger transactions is meant to reduce tax avoidance.

A number of amendments to the State Budget Act were passed in February. Hence, the establishment of an independent Fiscal Council, which is responsible for the assessment of the macroeconomic and financial forecasts and for monitoring compliance with the budgetary rules, is currently being implemented.

Financial Policy

The Estonian banking sector is highly liquid, well capitalized, and profitable and the balance sheets of the corporate and household sectors have improved, increasing the resilience to the external shocks. The Estonian banking sector is dominated by the Nordic (Swedish) banking groups, which own over 90 (80) percent of the market. As the real estate price cycle and household borrowing in Sweden have increased the risks to financial stability, the Estonian authorities welcome the steps by the Swedish authorities to further strengthen banks' capital and liquidity buffers. While the low interest rate environment has eased loan servicing, a prolonged period of monetary accommodation may encourage excessive risk-taking in Estonia, especially in the real estate market.

The strength of the Estonian banking sector is reflected by a high capital adequacy ratio that exceeded 24 percent in end-2013 and by liquid assets that constituted 24 percent of total banking sector assets. As a sign of decreased vulnerability, the loan-to-deposit ratio declined to the 104 percent level in the beginning of this year. Throughout 2013, the level of NPLs has fallen reaching below 2 percent in 2014.

The contraction in the corporate sector credit stock came to an end in mid-2012. However, the recovery stalled a year later as uncertainties in the external environment affected credit demand. The corporate sector balance sheets and bank lending policies are not constraints to credit growth. The predominant factor for the continuation of credit recovery is the renewed growth of Estonia's major trade partners.

Real estate price developments in Estonia constitute an evolving risk that requires close monitoring. Following a steep decline in the recession years and a vigorous recovery thereafter, apartment prices were still raising by more than 20 percent annually at the end of 2013. Low interest rates enhance the risk that continued growth in real estate prices leads to overly optimistic expectations. An encouraging sign is that a relatively high share of real estate transactions is not credit funded. The planned amendments to the Eesti Pank Act will give the Bank of Estonia the powers of the macro-prudential authority and the Credit Institutions Act defines the implementation of macro-prudential instruments. The expectation is that some of the instruments will come into force over the course of 2014. Given the highly integrated Estonian and Nordic banking sectors, it is important that the modalities arising from the implementation of the EU Banking Union will be effectively integrated into the existing Nordic-Baltic bank supervision and policy cooperation framework.

Structural Policy

Although the income level has considerably increased in Estonia during the last two decades, the gap with the EU average still exists. The Estonian authorities recognize that continued convergence prescribes behavioral and structural flexibility, which is not granted.

Against the background of population aging and migration, affecting potentially future investments, the authorities are concerned about the high level of structural unemployment. They share the view that policies need to address skill mismatches as a high priority. Lowering the tax wedge, which they have already implemented, may also help, but this measure is likely less efficient when skill imbalances between demand and supply are present. Measures that make vocational training more available, competitive, and adaptive to the labor market needs, have been put in place. Nevertheless, skilled labor is highly scarce in some segments of the economy. The Estonian Unemployment Insurance Fund (EUIF) will continue providing their updated and diversified portfolio of ALMPs. The EUIF’s spending will increase by 15 percent in 2014, which allows them to provide more services, especially against the background of a smaller number of unemployed people. Following the draft act of the disability benefit reform, the mandate of the EUIF will be broadened in 2015 to include the assessment of work capacity for disabled people. This reform is likely to increase labor supply as it aims to bring more disabled people to the labor force and to prevent the loss of their work capacity.

Estonia has made progress in connecting its electric grids with Finland, which has resulted in a substantial decline in price differentials between two countries. Discussions are ongoing with Finland to build the Baltic Connector and LNG terminals to connect the gas grids as well and improve energy security. The Estonian authorities are strongly in favor of fast progress in the Rail Baltic project, to improve the rail connection of the whole region with the rest of the EU.