EXECUTIVE BOARD MEETING

SM/19/284
Correction 1

January 10, 2020

To:	Members of the Executive Board
From:	The Secretary
Subject:	**Republic of Estonia—Staff Report for the 2019 Article IV Consultation**

Board Action:	The attached corrections to SM/19/284 (12/23/19) have been provided by the staff:
Factual Errors Not Affecting the Presentation of Staff's Analysis or Views	**Pages 1, 6, 19**
Questions:	Mr. Gueye, EUR (ext. 37182) Mr. Chawani, EUR (ext. 36777) Mr. Eklou, EUR (ext. 37683)

INTERNATIONAL MONETARY FUND

REPUBLIC OF ESTONIA

STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION

December 19, 2019

KEY ISSUES

Th economy has performed well in recent years, supported by prudent management and effective structural reforms. Growth remains strong and unemployment is at a record low. Inflation is above the euro-area average, consistent with Estonia's convergence process. Wages are rising, reflecting a tight labor market and skill shortages at the high end of the labor market. Absent reforms to boost productivity and manage demographic challenges, however, growth will slow notably. The authorities need to guard against potential overheating in the near term while taking advantage of sizable fiscal buffers in the medium term to support innovation and labor supply and reduce inequality.

Key Policy Recommendations

- Use the substantial fiscal space to enhance potential growth over the medium term by investing in productive physical infrastructure and human capital development. Over the near term, as the economy is operating above potential, wind down the positive fiscal impulse of recent years.

- Accelerate structural reforms that strengthen innovation and help labor supply, to boost productivity. Enhance labor participation by improving the work ability reforms, implementing active market labor policies, and raising the efficiency of social spending.

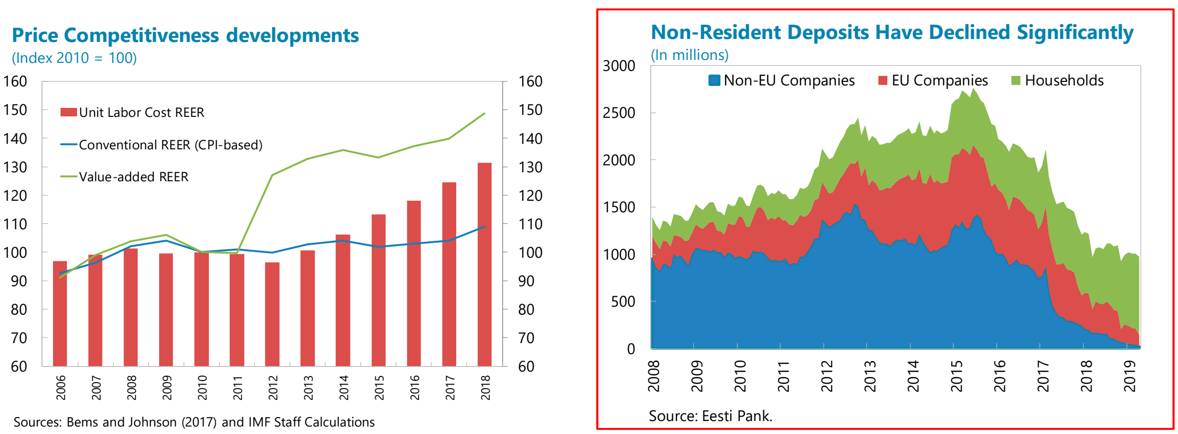
- Consider changes that preserve the pension system's viability and sustainability, while promoting policies that address inequality. This includes raising female labor participation through broader implementation of gender pay transparency and flexible childcare arrangements.

- Enhance macroprudential policies and the AML/CFT framework. Closely monitor macrofinancial and housing market developments and stand ready, with an enhanced toolkit, to act as needed. Strengthen AML/CFT banking supervision by increasing the number of on-site inspections, ensuring timely and dissuasive fines, and considering its consolidation at the ~~national~~ regional level.

6. The current account (CA) surplus narrowed, but the external position is assessed to be substantially stronger than justified by fundamentals:

- The CA surplus decreased to 1.7 percent of GDP in 2018, from 3.2 percent a year earlier (Text figure 3), mostly reflecting steady growth in domestic demand that outpaced strong export performance. The surplus continued to narrow in 2019H1 owing to sustained internal demand and moderating foreign demand on the back of an uncertain global environment marked by trade tensions. While there is no evidence of weakened competitiveness in the CPI-based REER, the value-added-based REER—which accounts for the fact that much of Estonia's output comes as one stage in complex global value-added chains (GVCs)—suggests some loss of competitiveness over the last decade (Text figure 4, SIP: "Competitiveness and GVCs).
- The external position is assessed to be substantially stronger than justified by medium-term fundamentals and desirable policies, with an estimated CA gap of 4.3 percent of GDP (Annex III). This assessment considers structural changes, but policies, notably Estonia's strong fiscal position, have contributed as well. The policy gap is estimated at 2.2 percent of GDP, reflecting mostly the need for more cost-effective public health spending amid unfavorable demographics.

Text Figure 4. Price Competitiveness and Non-Resident Deposits



7. Financial soundness indicators suggest that the banking system remains strong, despite concerns about AML/CFT developments:

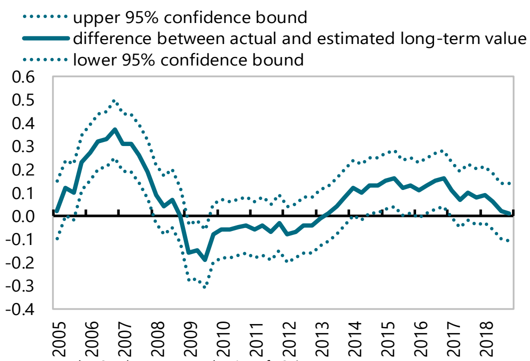
- Financial soundness indicators (Table 8) suggest that the banking system remains healthy. The growth of bank lending and leasing combined for non-financial corporations and households eased to 5 percent (y/y) in October 2019 from 7.1 percent in June 2019. Lending standards remain tight and may reflect on-going concerns about the insolvency regime's problems.[3] The average interest rate, though low in absolute terms, is high compared to that of peers, as interest margins are wider due to official operations, but also low competition.
- Despite progress in implementing AML/CFT international standards, recent allegations of money laundering led the authorities to close the branch of Danske bank. However, the impact of this

[3] The insolvency regime is characterized by a longer time before starting another business, inability to initiate restructuring, lack of an early warning mechanism and special insolvency procedures for SMEs.

applies to these two banks. In line with credit and nominal output developments, and the credit gap, the countercyclical capital buffer is appropriately set at zero.

Text Figure 11. Macroprudential Developments

Housing Market Price Developments

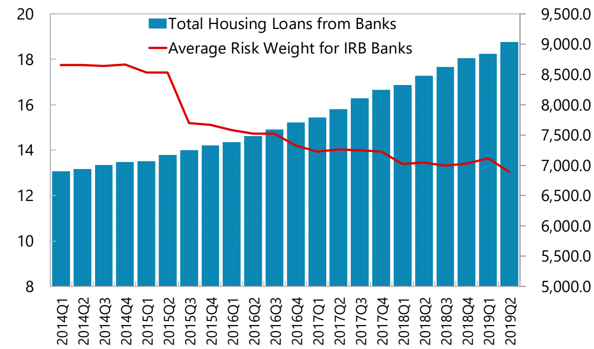


Note. Value 0.1 denotes overvaluation of 10%.

Sources: Statistics Estonia, Eesti Pank

Housing Loans and Risks Weight for Mortgage Loans

(Percent, million euros)



Source: Eesti Pank

35. The AML/CFT regime has improved, amid increased international scrutiny (SIP: "AML/CFT Supervision"). Cases involving banks operating in Estonia have drawn scrutiny and affected the reputation of the financial sector. In this context, the Estonian Financial Supervisory Authority (EFSA) has continued to refine its extensive off-site supervision, conduct full-scope on-site inspections, and actively employ its powers, including precepts and license withdrawals, to enforce financial institutions' compliance with their AML/CFT-related obligations. More broadly, the AML/CFT maximum fine has been increased, and additional resources devoted to countering illicit finance. Also, the EFSA issued extensive guidelines to supervised entities, conducted an in-depth review of bank risk profiles and initiated preparation of a new ML/TF national risk assessment.

36. Continued reform, including of AML/CFT supervision, will be critical to mitigate evolving risks. The process to impose monetary penalties for AML/CFT violations should be streamlined, and the maximum penalty further increased. The number of financial institutions that may be covered by inspections each year should be increased by introducing risk-based targeted and thematic AML/CFT inspections and/or further increasing supervisory resources. The recently-approved Center for Strategic Analysis should be created expeditiously and fully operationalized, with adequate capacity. Finally, government should hold internal discussions on consolidating AML/CFT supervision at the EU or Nordic-Baltic levels and arrive at a formal position. The AML/CFT regime is scheduled to undergo an assessment by MONEYVAL[16] in ~~2022~~2021. Potential impact of AML/CFT risks on the macroeconomy is yet to be quantified.

[16] The Council of Europe's Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism.