May 12, 2020
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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 20/6-2

11:35 a.m., January 17, 2020

2. Republic of Estonia—2019 Article IV Consultation

Documents: SM/19/284 and Correction 1; and Supplement 1; SM/20/3; and Correction 1

Staff: Gueye, EUR; Wiegand, SPR

Length: 49 minutes

Executive Board Attendance

T. Zhang, Acting Chair

Executive Directors	Alternate Executive Directors
	O. Odonye (AE), Temporary
	F. Sylla (AF)
	J. Di Tata (AG)
	N. Heo (AP)
	P. Fachada (BR)
	Y. Zhao (CC), Temporary
	J. Montero (CE), Temporary
	A. McKiernan (CO)
	C. Just (EC)
	P. Rozan (FF)
	K. Merk (GR)
	P. Dhillon (IN), Temporary
	M. Psalidopoulos (IT)
	K. Chikada (JA)
	M. El Qorchi (MD)
	D. Fadhel (MI), Temporary
A. De Lannoy (NE)	
T. Ostros (NO)	
	D. Shestakov (RU), Temporary
	R. Alkhareif (SA)
	A. Muslimin (ST), Temporary
	P. Trabinski (SZ)
S. Riach (UK)	
	P. Pollard (US), Temporary

C. McDonald, Acting Secretary
H. Malothra, Summing Up Officer
D. Alcantara, Board Operations Officer
L. Nagy-Baker, Verbatim Reporting Officer

Also Present
European Central Bank: K. Nikolaou. European Department: R. Chawani, K. Eklou, P. Gerson, C. Gueye. Legal Department: M. Markevych, E. Mathias, J. Purcell, D. Schwarz. Strategy, Policy, and Review Department: J. Wiegand. World Bank Group: R. Rampre. Office of Executive Directors: J. Al Saud. Alternate Executive Director: L. Palei (RU). Senior Advisors to Executive Directors: Y. Danenov (SZ), M.Gilliot (FF), N. Jost (NE).

Advisors to Executive Directors: W. Al Hafedh (SA), D. Andreicut (UK), S. Belhaj (MD), M. Bernatavicius (NO), E. Boukpessi (AF), L. Cerami (IT), H. Koh (GR), A. Maciá (BR), M. Mehmedi (EC), P. Mooney (CO), T. Nagase (JA), E. Ondo Bile (AF), B. Parkanyi (NE), S. Senich (US), N. Vaikla (NO).

2. REPUBLIC OF ESTONIA—2019 ARTICLE IV CONSULTATION

Mr. Ostros and Mr. Vaikla submitted the following statement:

Macroeconomic performance and outlook

Estonia has witnessed solid economic growth in recent years as the economy has operated above its potential. The GDP growth in 2019 was around 3.5 percent driven by investments and strong private consumption, fueled by rapid growth in wages, and low unemployment. The manufacturing, information technology, and business services sectors had the most impact to the GDP increase, while construction and the energy sector contributed negatively to growth. The economic growth of 4.2 percent in the third quarter was surprisingly good but was lifted by one-off factors related to the agricultural sector and changes in consumption taxes.

Going forward, the Estonian economy will witness a gentle deceleration as the weaker outlook for foreign markets weighs on the manufacturing sector and exports. These developments, coupled with the stabilization of employment and a more modest growth of incomes, will somewhat ease consumption growth going forward. As a result, growth in the economy is expected to pull down close to 2 percent in the years ahead, while inflation will continue to rise slowly at a rate of around 2 percent.

The labor market is tight as the unemployment rate has declined to a record low level of 3.9 percent, while the labor force participation rate remains one of the highest in the EU. The limited labor supply has been somewhat eased by immigration, which has exceeded emigration for the past four years now. There has especially been an increase in recent years in temporary migration from outside the EU, which has significantly eased labor shortage pressures in certain sectors. The first signs of cooling are apparent in the labor market, as the more recent rise in registered unemployment and increasingly pessimistic employment expectations in the manufacturing sector indicate that the unemployment rate is expected to rise. The tight labor market conditions have resulted in rapid wage growth averaging 7-8 percent annually in recent years. With the economic climate cooling, the authorities expect that wage growth will ease somewhat, while wage pressures will probably remain relatively high in the future.

The authorities agree that risks to the growth outlook are skewed to the downside. Estonia's small and very open economy is particularly vulnerable to the external environment. Therefore, weaker economic prospects for its immediate trading partners, trade tensions, and Brexit concerns could significantly hamper Estonia´s economic activity through the exporting sector. Domestically, risks could stem from the overheating of economy as limited labor has imposed strong cost pressures on companies thereby posing a risk to Estonia´s competitiveness and productivity.

Fiscal policy

Estonia is committed to pursue a sound and sustainable fiscal policy, which has served the country well and provided macroeconomic stability. Fiscal policy is aimed to preserve neutral or countercyclical budgetary policy, while maintaining the low level of government debt. Estonia’s gross public debt is currently at around 9 percent of GDP and net debt is close to zero due to sizable liquid reserves. The Ministry of Finance expects that the general government’s 2019 nominal budgetary position was close to balance (-0.1 percent of GDP), while the structural position improved to -1.2 percent of GDP. The authorities concur with staff that with the economy operating above its potential, the current expansionary fiscal stance needs to be gradually unwound. The State Budget envisages that in 2020 the budget will be in nominal balance and the structural position further improves to -0.7 percent of GDP.

The Government´s fiscal policy aims to improve social cohesion and reduce inequality, while maintaining prudent public finances. To set the fiscal policy towards more growth-friendly direction and to simplify the fiscal rule, the government is considering considers amending the current rule by waiving the requirement to compensate for the cumulative deficit that has arisen, and to restore the annual structural balance requirement. To improve the social safety net and meet the Government´s goal of reducing relative poverty to 15 percent by 2023, pensions will continue to grow in 2020 supported by extraordinary increase, while further investments are made to health care, social security, and education. The 2018 income tax reform, which raised the non-taxable income threshold and made the system more progressive, considerably improved inclusiveness and inequality. Last year, additional one-time benefits were paid to pensioners living alone, while family allowances were raised. According to OECD estimates, the combined effect of these measures reduced the Gini index of disposable incomes by roughly one percentage point. However, the authorities agree with staff that there is further scope to address wealth inequality.

The authorities agree that fiscal policy should be geared towards raising potential growth over the medium to long term by implementing productivity-enhancing investments, while fiscal space should be used to ensure positive returns for the entire economy without causing labor market distortions. The Government plans to implement multi-decade investment projects to upgrade infrastructure. The construction of Rail Baltica, a rail transport infrastructure project to integrate Baltic economies in the European rail network, is already in progress, while large-scale PPP infrastructure projects are considered to further improve transport connectivity. The authorities concur with staff that higher investment expenditures should be supported by improved efficiency of public spending and are committed to strengthening public investment management and a partnership framework for public-private investment, in-line with the PIMA recommendations.

The Government also prioritizes the development of a competitive economic environment and is taking steps to reduce excessive administrative burdens. On this regard, the Government has approved the initial state reform action plan for 2019-2023 aimed toward increasing the effectiveness of state tasks, lowering the administrative burden, and decreasing expenditures in the government sector.

Structural Policies

Given the already high employment rates and demographic challenges in the economy, the authorities acknowledge that there is a growing need to implement structural policies geared toward accelerating productivity and reducing skill gaps.

Productivity

The authorities agree with staff that scaling up public and private investment in R&D would broaden the economy´s innovation base and significantly enhance productivity. The Government has set the long-term target of increasing the private sector's R&D expenditure to 2 percent and the public sector's R&D expenditure to 1 percent of GDP. Additional resources in the 2020 budget are devoted to R&D with the aim of boosting productivity, which will further raise the share of science funding to 0.74 percent of GDP. A formation of joint strategy for R&D, innovation and entrepreneurship is currently being developed to reach the set targets with emphasis on significantly increasing the share of private sector investments. As a new measure, there are plans to set up a support fund for research and development intensive start-ups. While R&D spending has risen over the years in absolute terms, the authorities share staff´s view that there is scope to step up R&D

expenditure to raise productivity and support convergence to EU income levels.

Labor market reforms

The Work Ability Reform has overhauled the disability pension system and unlocked resources for lower paid sectors. To further ease the tight labor market, the authorities have loosened restrictions in certain branches of the economy on hiring foreign labor outside of EU. The rapid wage increase, which has been consistently above productivity growth in recent years, is a concern and the authorities agree that high quality labor market policies aimed toward reducing skill gaps is important going forward. To alleviate skill shortages, the authorities are implementing measures to improve adults' access to formal education, expand opportunities of in-service training and retraining. Higher and vocational education and retraining programs are being amended to ensure that the education system meets the needs of the labor market.

While the female employment participation rate is one of the highest in the EU, the relatively high gender pay gap, albeit on the downward trend over the years, is a concern for the authorities. To reduce the high gender pay gap in the private sector, a comprehensive evaluation of enterprises work and pay systems is planned and will be made available to employers to support them both in fulfilling legal requirements and taking voluntary measures to promote gender equality in their organization. Additional activities are being implemented to improve economic opportunities for women by providing adequate and flexible childcare arrangements and to increase paternity leave.

Pension reforms

In 2018, Estonia adopted the first pillar pension reform changing the pension formula and linking the pensionable age with life expectancy starting from 2027. These measures will support labor supply and increase average pensions in the future, especially for low-income earners.

The Government has announced plans to implement changes to the second pillar of the pension system in 2020 with the aim of making the pension system more flexible. The proposal, yet to be approved by the Parliament, allows individuals to opt-out from the mandatory privately-managed second pillar and gives them an opportunity to withdraw the accumulated funds before the retirement age. The planned changes also provide option to receive the second pillar pension as a lump sum or as an annuity from the pension fund or an insurance company.

The Bank of Estonia fully agrees with staff that the planned changes to the pension system will endanger macroeconomic stability as temporary boost fueled by increased consumption due to withdrawal of assets from pension accounts would be followed by slower growth or even a recession. In the long run, there is considerable risk that the planned reform would lower retirement incomes and raise old-age poverty, which ultimately results in higher fiscal costs. Risks to financial stability could stem from sell-off of investment assets, as pension funds need to liquidate their investments, including less-liquid investments made in the domestic financial market.

Financial policy

Financial stability

The Estonian financial system continues to be sound with a well-capitalized, profitable, and liquid banking system. The bank’s loan portfolio has shown strong growth, mainly driven by households, while borrowing by companies has been moderate. However, the households’ ability to service their loans has remained good and their indebtedness has not increased as incomes have risen fast as well. Given the recent moderate rise in housing prices and the current state of the economy, imbalances in the housing market are not significant. The authorities monitor the developments in the housing market closely.

Risks to the financial sector are low and mainly external. The risks could result from weaker than expected global growth and volatile financial market conditions. The Estonian banking sector has strong interlinkages with the Swedish financial system, as subsidiaries of Swedish banks account for two thirds of the banking market in Estonia. While loan portfolios of the subsidiaries are funded almost entirely from domestic deposits, the funding risks of parent banks also affect the Estonian financial sector. Domestic risks stem mainly from the build-up of vulnerabilities related to strong growth in household borrowing and real estate development activity.

The Bank of Estonia has introduced various capital buffer requirements and requirements for issuing housing loans to reduce the risks to the financial sector. A systemic risk buffer requirement of 1 percent applies to all banks in Estonia, with additional capital buffers between 1-2 percent required for the four systemically important credit institutions. As a new macroprudential measure, an average risk weight floor of 15 percent for mortgage loans was introduced for banks that use the internal ratings method for calculating risk-weighted assets. While the level of systemic risk coming from the housing market is not currently high, the aim of the measure is to ensure the resilience of the banks to the risks associated with housing loans.

AML/CFT developments

The authorities are concerned that the Estonian banking sector has been used for money laundering and are strongly committed to further strengthening the AML/CFT regime. The authorities have recently closed two banks that have breached the requirements of AML/CFT laws. As a result, the share of deposits held by non-residents in the Estonian banking sector have fallen dramatically in the past three years thereby substantially reducing the risks to the banking system. The authorities have recently reviewed the functioning of the AML institutional set up and related proceedings to ensure its effectiveness and to strengthen its AML/CFT regime more generally. The Estonian FSA has notably increased the number of staff to counter illicit finance, issued extensive guidelines to supervised entities, and conducted an in-depth review of bank risk profiles.

As a top priority for the Government, the authorities are taking forceful steps in the fight against money laundering by improving prevention and enhancing domestic and international cooperation regarding AML/CFT policies. Further funds have been allocated to the FIU and Prosecutor’s Office in this year´s budget and a Center for Strategic Analysis was established under the FIU, which will significantly improve the scope of preventing money laundering. On the legislative front, the Government approved the draft legislation, which improves the state’s possibilities to combat money laundering and transposes the EU Anti-Money Laundering Directive (AMLD V) into Estonian law. The legislation will significantly increase the fines for money laundering offences, as well as to expand the circle of persons who must comply with the requirements of the Money Laundering Prevention Act. The Estonian AML/CFT regime is scheduled to undergo an assessment by MONEYVAL in 2021.

Nordic-Baltic cooperation

The Estonian banking sector is closely interconnected with the Nordic-Baltic countries, therefore close cooperation within the region is essential. In January 2019, the Nordic and Baltic financial stability authorities conducted a joint financial crisis management exercise to strengthen the financial crisis preparedness. Based on the test results, follow-up work is planned for the coming years with the aim to enhance communication and collaboration between the Nordic-Baltic authorities. In addition, the authorities agree on the need for broader regional cooperation to strengthen AML/CFT supervision. In August 2019, the Nordic and Baltic financial supervisors agreed to establish a permanent working group to exchange experiences and information with the goal of being more effective in the prevention of money laundering.

Mr. Di Tata, Mr. Tan, Mr. Anwar and Mr. Corvalan Mendoza submitted the following joint statement:

We thank staff for the insightful set of papers and Mr. Ostros and Mr. Vaikla for their informative buff statement.

We commend the authorities for maintaining prudent macroeconomic management and implementing structural reforms that have improved the performance of the Estonian economy in recent years. Real GDP growth eased to 4 percent in 2019, with core inflation averaging 2 percent over the first half of the year. The unemployment rate has fallen below 4 percent, while labor force participation has increased in response to work ability reform and integration of migrant workers. Wage growth, however, continues to exceed productivity growth. The fiscal outlook remains accommodative, but the public debt stands at just 8 percent of GDP. The near-term outlook is favorable but economic growth is expected to slow gradually to 2.8 percent over the medium term, with external and domestic risks tilted to the downside. Against this backdrop, there is a need to keep macroeconomic policies well-calibrated and to accelerate structural reforms to raise productivity and promote strong and inclusive growth. We share the broad thrust of the staff report and have the following remarks for emphasis.

An appropriate policy mix is essential to strengthen Estonia’s economic performance over the near- and medium-term. We welcome the broad agreement between staff and the authorities on the policy mix. On fiscal policy, it is crucial to mitigate imbalances in the short run and support inclusive and sustainable growth in the long run. In this regard, we concur with the view that the current expansionary fiscal stance needs to be gradually unwound, given that the economy is operating above its potential. We also take positive note of the orientation of fiscal policy toward improving social cohesion and reducing inequality. Given the low interest rate environment, macroprudential policy should help to contain financial sector risks.

The medium-to-long term fiscal policy should consider the sizeable fiscal space and gear toward raising potential output growth by implementing productivity-enhancing investments. In this regard, we associate ourselves with staff in commending the authorities' agenda to strengthen public investment management (PIM), particularly on planning and resource allocation, and encourage the authorities to keep public sector wages anchored to productivity growth in the broader economy. Given the limited progress that has been made in implementing the PIMA recommendations, efforts should also be intensified in this area. At the same time, preserving the viability and sustainability of the pension system is essential. In this regard, we encourage the authorities to review the pension system in line with staff's recommendation to keep the pillar II as mandatory while addressing its shortcomings. We invite staff to comment on the feasible options to mitigate the potential implications should the government continues with the process to make pillar II voluntary.

Strengthening AML/CFT and macroprudential frameworks as well as cross-border supervision are necessary to safeguard the stability of the financial system. We note that banks are profitable, liquid, and solvent, and commend the authorities for the progress made in enhancing macroprudential policies. At the same time, we encourage them to address AML/CFT concerns that could pose both reputational and stability risks, as well as remain vigilant of housing market developments. We would appreciate staff's comments on the pass-through effects of the international trade risks and the real estate sector to the Estonia's banking system. Could staff also elaborate the progress made in strengthening cross-border supervision and the results of the crisis simulation exercise for the eight Nordic-Baltic countries?

Further efforts are needed to accelerate structural reforms in order to boost productivity and competitiveness. We welcome the recent progress in structural reforms, including the 2018 labor tax reform, which helped reduce the labor wedge for low-income earners. Notwithstanding advances made over the last decade, income inequality and poverty remain elevated and the gender pay gap is large. Against this backdrop, we agree with staff on the need to preserve the strong gains made in labor participation and employment, accelerate labor market reforms, further expand firms' innovation capacity, and enhance public and private investment in research and development. In addition, there is a need to extend the availability of childcare to provide greater opportunities for women and strengthen the social safety net for the older population. With respect to the structural reform recommendation to increase state financing for R&D to at least 1 percent of GDP, we note the authorities' clarification that budgetary constraints were slowing progress to achieve this target. Given these circumstances and despite closer oversight by the Research and Development Council (RDC) in the Prime Minister's Office, we invite staff to elaborate their assessment of the effectiveness of the RDC and the potential corrective measures.

With these comments, we wish Estonia and its people every success in their future endeavors.

Ms. Levonian, Ms. McKiernan and Mr. Mooney submitted the following statement:

We thank staff for their reports, and Mr. Ostros and Mr. Vaikla for their useful and timely buff statement. Growth in the Estonian economy remains robust, with unemployment at low levels and a favorable business environment. However, challenges remain in the form of concerns around the AML/CFT framework and labor shortages in the highly skilled segment. We agree with the thrust of staff's assessment and offer the following points for emphasis.

We agree with staff that the large fiscal space should be utilized to enhance potential growth over the medium term by investing in productive physical infrastructure and human capital development. In terms of public sector wage growth, we note the general wage increase approved in the budget but, like staff, we agree that this should be anchored to productivity growth in the broader economy. We positively note the solid public investment management (PIM) framework and encourage the authorities to strengthen planning, allocation, and implementation of investments, in line with the Fund's FAD TA recommendations.

We positively note that the banking system remains profitable, liquid, and solvent. We welcome Estonia's participation in the crisis management simulation exercise of the Nordic-Baltic region in 2019 and concur with the staff view that the authorities should seek to enhance cross-border supervision, in line with the conclusion of this exercise. We agree with staff that macroprudential tools should stand ready to be activated in the event of the intensification of cyclical risks. As regards AML/CFT, we welcome the continued strengthening of the regime since the money laundering scandal. However, we urge the authorities to remain vigilant in this regard, ensuring that ongoing reform and enhanced monitoring are undertaken to address evolving risks in this area.

We note the elevated gender pay gap, as outlined in the Selected Issues paper (SIP), and welcome the authorities' commitments in this regard, as outlined in the buff, to provide adequate and flexible childcare arrangements and increase paternity leave. We note the conflicting views between the Ministry for Finance and Central Bank regarding the future of the pillar II pension system and agree with staff that there is scope to maintain the system as mandatory while tackling its perceived shortcomings. We welcome the analysis in the SIP regarding global value chains (GVCs) and concur with the staff view that policies aimed at enhancing product sophistication or quality and export market diversification could mitigate Estonia's exposure to trade shocks in GVCs. Finally, we welcome the authorities' plan to diversify electricity supply by investing in renewables and cleaner oil shale technology.

Ms. Pollard and Ms. Senich submitted the following statement:

We thank staff for the report and Mr. Ostros and Mr. Vaikla for the helpful buff statement. Estonia is in what many would consider to be an enviable macroeconomic environment of strong growth, low unemployment, extremely low public sector debt, and sound banking indicators. We take note of the risks from demographic changes and lagging productivity growth but see significant fiscal space for productive spending on priority areas. We generally concur with the thrust of the staff report but will highlight a few areas for emphasis.

While we agree with the report's overall recommendations to raise potential growth by spending more efficiently and effectively on priority sectors such as R&D, health, education, and infrastructure, we do not share staff's conclusion that the authorities should tighten fiscal policy in the short term. The staff report assesses the Estonian economy as currently growing above potential. While we appreciate the risks of an overheating economy on wage pressures and the real estate sector, we are not convinced that these risks are imminent. Inflation decelerated in 2019, households have been deleveraging, and economic activity is slowing toward potential. We agree with staff that in the medium-term the authorities have significant space to support measures that reduce inequality and support productive enhancing investment. Given Estonia's historical commitment to prudent fiscal policy, we would support more emphasis on improved spending rather than on less spending.

The staff appraisal of the potential changes resulting from the proposal to make pillar II of the pension system voluntary was alarming. We understand from the staff report and from Mr. Ostros and Mr. Vaikla's buff statement that there are varying degrees of support for the proposed changes.

We would encourage the Ministry of Finance to reconsider moving forward with the process to make pillar II voluntary.

The report's focus on structural reforms that improve productivity growth is appropriate. The authorities have made commitments to increase R&D spending, although much of the burden is placed on the private sector. The authorities have also made progress in increasing labor supply through its Work Ability Reform and through loosening restrictions on hiring foreign labor. We support the authorities' goals of reducing the high gender pay gap. We agree with staff that the authorities need to update the insolvency framework in order to increase the recovery rate and release capital for productive purposes.

We note the numerous steps that the authorities have taken to improve the AML-CFT regime in recent years, particularly the increase in staff in the Financial Supervisory Authority (FSA) and the increased budget of the Financial Intelligence Unit. Approval of legislation to improve anti-money laundering efforts and to incorporate the EU Anti-Money Laundering Directive into Estonian law are also important achievements. While Estonia has not formally assessed its AML/CFT risks at the national level since 2015, the authorities have taken significant steps in light of the recent banking scandals to mitigate certain risks to its financial sector. As the report notes, the authorities pursued significant reductions in non-resident deposits, which is a welcome step to bring the country's risk exposure in line with its ability to adequately supervise these accounts and activity. As Estonia's virtual asset service provider (VASP) market continues to grow, this may be the next area in which Estonia can focus its risk mitigation efforts.

We agree with staff that the authorities should consider either developing risk-based targeted and thematic on-site inspections, or further increasing staff in the FSA so that there is greater breadth of financial institution coverage. Estonia must be able to independently impose meaningful and dissuasive sanctions on banks for significant AML/CFT compliance failures. The low level of maximum fines under the AML-CFT sanctions process would also seem to do little to dissuade abuse, and we support the recommendation to increase the penalties for AML/CFT violations. Can staff provide an update on the status of the legislation that would increase the maximum fine for violations?

Mr. Jin and Ms. Zhao submitted the following statement:

We thank staff for the well-written report and Mr. Ostros and Mr. Vaikla for their informative buff statement. Estonia's economy continues to remain strong with good performance in the fiscal, financial, and external sectors. Going forward, sustained efforts to enhance productivity, as well as to maintain fiscal and financial soundness, will be the key to promote strong and inclusive growth. We broadly agree with staff's analysis and would like to limit our comments to the following points.

Appropriate policy mix is essential to strike a balance between addressing imbalances and supporting economic activity. Supported by a strong commitment to a prudent fiscal stance, Estonia runs a rather small fiscal deficit and public debt stays at a very low level. With a positive output gap, fiscal policy should unwind the positive fiscal stance in the near term. In the medium term, substantial fiscal space should be used to reorient fiscal policy to a more growth-friendly path, including by raising productivity-enhancing investments and enhancing public spending on R&D.

Strengthening macroprudential frameworks, AML/CFT regime. and cross-border supervision to safeguard the stability of the financial system is a priority. We take positive note that banks are profitable, liquid, and solvent, and commend the authorities for the progress made in enhancing macroprudential policies. At the same time, we encourage the authorities to remain vigilant of financial stability and closely monitor housing market exposures. We would appreciate staff's comments on the extent of improvements in banks' vulnerability to the real estate sector in recent years. Given the strong presence of Nordic banks in the local banking sector, enhanced cross-border supervision is needed.

Sustained efforts are needed to preserve competitiveness. Close monitoring of the impact of rising wages remains warranted. In the meantime, measures to raise productivity will be essential, and the substantial fiscal space could be used for measures to increase public investment and labor supply. We note that Estonia is one of the most digitally advanced nations in the world. Could staff elaborate what role the high digitalization can play in enhancing economic productivity and supporting the labor supply? Improving economic opportunities for women by closing the gender pay gap and further supporting childcare arrangements would also promote growth potential.

With these comments, we wish the authorities every success in their future endeavors.

Mr. Heo and Mr. David submitted the following statement:

We thank staff for the informative set of reports and Mr. Ostros and Mr. Vaikla for the helpful buff statement. Estonia has experienced strong economic growth due to its prudent macroeconomic management and structural reforms. With economic growth easing in 2018 and 2019, we are encouraged by the authorities' efforts to implement policy initiatives to sustain growth. However, more remains to be done to mitigate the downside external and domestic risks facing Estonia in the near-term. We broadly agree with staff's appraisal and offer the following comments.

Prudent fiscal policy and debt management has created adequate fiscal space. The fiscal space would assist the authorities implement productivity-enhancing investments and deal with negative external shocks. We note the declining trend in total external debt, which reached 76.2 percent of GDP in 2018, of which public sector debt comprised 8.3 percent of GDP, one of the lowest in the EU. We note staff's assessment that there are no major external debt sustainability concerns. Could staff advise on what assessments have been done on the currency and maturity profiles for the large private sector external debt? We agree with staff that while the net international investment position has improved, improvements were needed to enhance Estonia's resilience against shocks from an ageing population and volatile portfolio flows. We are encouraged by the authorities' commitment to strengthen public investment management in line with the PIMA recommendations.

Enhancing supervision and addressing AML/CFT concerns would strengthen financial stability. We note that Estonia has a sound banking system which is well-capitalized, profitable and having low NPLs. Nonetheless, continued vigilance is important to maintain stability, including with neighboring countries' agencies. We are therefore encouraged by the joint financial crisis management exercise held in early 2019 involving 31 authorities from the eight Nordic-Baltic countries. Apart from the need to improve coordination and communication between agencies of the home and host countries, what other key lessons were acquired from the simulation exercise? AML/CFT supervision remains a challenge and we welcome the ongoing efforts to strengthen the AML/CFT framework, including an assessment by MONEYVAL in 2022.

Structural reforms are required to help improve labor market productivity. We see merit in utilizing the fiscal space to speed up structural reforms, especially in the labor market. This is in light of the challenges in the workforce with an ageing population, skills shortage and rising wages. We note that the trend in the declining population is mainly due to migration and low fertility rates, which has contributed to the tight labor market. Reforms to increase labor force participation, especially for women and youth, would help address this concern.

Mr. Mozhin and Mr. Shestakov submitted the following statement:

We thank staff for the informative report and Mr. Ostros and Mr. Vaikla for their well-written buff statement. Real economic growth of the Estonian economy had reached its peak of 5.7 percent in 2017 and continued to slow down moderately, but remains robust, reflecting strong economic fundamentals. The balance of risks to the economy is tilted to the downside, including weak growth in key trading partners. Tighter labor market conditions may result in inflationary pressures. In order to preserve the growth momentum, the authorities should continue implementing their reform agenda, manage demographic headwinds, and enhance productivity growth. Over the medium term investments in physical infrastructure and human capital should remain a priority.

With gross public debt at just 8 percent of GDP the Estonian authorities possess ample fiscal buffers to accommodate increases in public investments, as well as health and education spending. At the same time, the expansionary fiscal stance is likely to be suboptimal in the presence of a positive output gap and the accommodating financial conditions. On balance, we agree with staff recommendation that unwinding the fiscal expansion could be done gradually, without the sizable consolidation in the near term and subject to monitoring inflationary pressures. We would like to caution against the weakening of the fiscal rule, which the authorities plan to amend to waive the requirement to compensate for the past cumulative deficits. The fiscal management and accountability might be bolstered with the Fund's fiscal transparency evaluation in the near future.

Staff calculations of the value-added-based REER and unit labor costs suggest a gradual erosion of competitiveness of the Estonian economy over the last decade. Growing contribution of short-term foreign labor might slow the productivity growth even further and cause a larger divergence between wage and productivity growth. Public sector wages should be better anchored by economic fundamentals and would provide a demonstration effect for the private sector wage setting. We note the authorities' success in reducing the labor wedge for low-income earners, which provides stronger incentives to work. At the same time, the reform's impact on income inequality has remained marginal. Growing wages might induce technological changes aimed at reducing labor costs, which may well reinforce the effects already stemming from the widely spread digitalization the Estonian economy. So far, however, productivity growth appears to be moderate. We would like staff to elaborate on the main barriers for higher productivity growth in Estonia.

We welcome the progress in reducing income inequality in Estonia. In Estonia, the proportion of the population that is persistently at risk of poverty is greater than the EU28 average, and even more so for women and old-age population. While the unadjusted gender pay gap (GPG) decreased by 28 percent between 2010 and 2017 at the mean, most of this gap cannot be explained by male/female differences in characteristics and, according to staff, might reflect biased practices against women on the labor market. Further extensions of the pay transparency in the private sector will help in reducing GPG, while preserving Estonia's gains in female labor participation. We agree with staff that increases in social protection spending might lead to large inequality reduction and protect population at risk of poverty. We would like to know more about specific measures to enhance social spending efficiency and volume that might be considered by the authorities.

We commend the authorities for the progress in implementing the AML/CFT international standards. We note that, according to staff, recent closure of the Estonian branch of Danske Bank after the money laundering scandal is unlikely to significantly affect the overall banking system financial stability. Given the lingering reputational risks, however, we encourage the authorities to enhance expeditiously cross-border supervision and strengthen the effectiveness of the AML/CFT framework.

With these remarks, we wish the authorities every success.

Mr. Trabinski and Mr. Danenov submitted the following statement:

We thank staff for an informative set of papers and Mr. Ostros and Mr. Vaikla for their insightful buff statement. Estonia's robust growth has continued on the back of rising consumption and investment, and thanks to a favorable business environment. The near-term outlook is positive, while economic activity is expected to moderate in the medium term. However, downside risk related to an exacerbation of trade tensions and potential financial tightening poses a challenge to the outlook. Moreover, the wage growth, which exceeds productivity gains, is currently translating into a weaker competitiveness. In the context of demographic challenges, this will put significant pressure on long-term growth.

The available fiscal space could be used to increase potential growth over the medium-term. We note the authorities' commitment to fiscal discipline, as emphasized in the buff. With low public debt levels and substantial fiscal buffers, the authorities have supportive conditions for addressing longer-term challenges. We commend the authorities' structural policies developed around the "Estonia 2020" strategy. More specifically, the progress achieved on the educational front has helped to improve overall outcomes of the education system. This was recently reflected by Estonia's top position in the 2018 PISA among the European countries. Going forward, we encourage the authorities to focus on increasing spending on R&D, creating incentives for greater investment in innovation among the SMEs, and higher investment in public infrastructure. Could staff elaborate more on the size of infrastructure deficits in Estonia?

We appreciate the efforts of the Estonian authorities to reduce inequalities. We believe that in the context of the tight labor market, further fiscal and structural reforms supporting the labor supply are needed. Since 2015 the authorities have implemented a tax reform aimed at shifting the tax burden from labor to consumption. The reform has lowered the tax on low- and medium-income earners and reduced the tax wedge. Despite these efforts, the level of income inequality remains high. We therefore support further fiscal measures geared towards this objective. In addition, labor market policies and vocational training could be enhanced to reduce skill mismatches and to support greater labor force participation and full-time employment of disadvantaged parts of population. Moreover, we welcome the authorities' efforts to reduce the gender pay gap, in particular the plans to provide adequate childcare arrangements and to increase paternity leave, as well as the implementation of a comprehensive evaluation of corporate work and pay systems.

The financial system is sound, and we commend the authorities for the measures to strengthen the AML/CFT regime. We note the declining risk weights in two systemic banks using the IRB models and the central banks' decision to introduce an average risk weight of 15 percent for mortgage loans. In this vein, we would like to ask staff whether the integration of Basel output floors into the EU rules on capital adequacy would change the so far very good capitalization of Estonian banks. We note a significant decline of RoE in 2019Q2, and a concurrent decline in RoE in this period, the reason of which is not explained in the report. Staff's comments would be welcomed.

Mr. Chikada and Mr. Nagase submitted the following statement:

We thank staff for the insightful papers and Mr. Ostros and Mr. Vaikla for their informative buff statement. It is encouraging to see that Estonia's economy has performed well in recent years. However, to address international and domestic risks, and secure its sustainable growth, the authorities need steadily implement structural policies to accelerate productivity and reduce skill gaps. As we broadly concur with the thrust of the staff appraisal, we would like to limit our comments as follows:

To support growth and address demographic changes in the future, fiscal policy should be used and designed strategically. We commend that Estonia maintains its fiscal soundness despite recent increase of health and education expenditure. We encourage the authorities to tackle the both near-term and medium-to-long term policy challenges while the fiscal situation remains favorable. In this regard, we support the staff's recommendation to increase government spending by utilizing their substantial fiscal space to support productivity growth and help external rebalancing from medium-to-long term viewpoint.

Accelerating structural reforms is needed to boost productivity and address inequality. Although the employment and labor force participation rates have increased, we note with a concern that the productivity growth in Estonia remain weak since the global financial crisis and the population aging is estimated to suppress its long-term growth rate. Moreover, we note that Estonia has relatively high poverty rate and gender pay gap. To tackle these problems, we encourage the authorities to make strengthened efforts in tax and labor market reforms and increase social spending.

Strengthening the AML/CFT regime is warranted. We welcome the banking system in Estonia remains strong and the authorities are making efforts to improve compliance of the sector by conducting in-depth review and introducing a new national risk assessment. We encourage the authorities to continue strengthening the AML/CFT framework as staff proposed.

Mr. El Qorchi and Mr. Belhaj submitted the following statement:

We thank staff for the well-written set of reports and Mr. Ostros and Mr. Vaikla for their helpful buff statement. Despite a slight reduction in growth from 2018, Estonia's macroeconomic performance is satisfactory. Growth is above potential, unemployment is at a low level, debt is also remarkably low by international standards, budget and current account deficits are small, and inflation is decelerating. Estonia is an example which demonstrates the importance of having strong institutions and a willingness to implement market-oriented reforms. We broadly agree with the staff appraisal and would like to make the following comments.

Despite the good macroeconomic performance, the economy is showing signs of increasing structural constraints to growth that need to be integrated in the Government's policy agenda. These constraints include demographic change, tightening labor market, and slowing of productivity gains and global demand.

We agree with staff medium- and long-term fiscal policy recommendations. We encourage the authorities to use the ample fiscal space to boost growth potential, including through innovation, research and development, and investment in human capital. Productivity gains will contribute to mitigating the effect of the increase in unit labor costs and to ensuring consistency between the legitimate objective of closing the wage gap with European peers and preserving the competitiveness of the economy.

In the short term, however, the recommendation to end the accommodative fiscal stance might place the authorities in a dilemma of either reducing transfers to households and wage increases in priority occupations or deferring public investment. In this vein, we would welcome comments from staff on the urgency of the recommendation given the extremely low debt level, and on the nature of the savings from recurrent expenditure they suggested to the authorities to observe the fiscal rule.

Alongside the good macroeconomic performance, inequality and relative poverty in Estonia remain high compared to the EU average, and there is scope for further progress in the area of social policies. Demographic developments in Estonia pose serious challenges to the authorities considering the expected decline in the labor force, rising wage pressure, expected additional budgetary costs on pensions, and increasing poverty among older people. The response to these challenges needs to be multifaceted, ranging from productivity enhancement and long-term growth policies to labor and social reforms that would improve the employability of the low-skilled and encourage women to join the labor force. In 2016 Article IV assessment, staff highlighted the limited attractiveness of Estonia's life-long learning strategy, we would welcome staff comments on the recent developments in this regard.

Measures to support female labor supply are welcome, including reducing the gender pay gap and improving childcare facilities. An informed and pragmatic approach to immigration is also an important part of the solution. As regards the pension system, we agree with staff that making participation in the second pillar voluntary would put pensioners in a precarious situation and would increase the risk of poverty in old age. We advocate greater inclusion and spending on social benefits that would preserve stability, social coherence, and maintain popular support for market-oriented reforms.

We commend the authorities for their strong commitment and the progress made in strengthening the AML/CFT framework. However, we note that AML/CFT remains a concern. We agree with staff that the Estonian Financial Supervisory Authority should be given all possible means to increase its effectiveness and coverage. We also support staff’s proposal to carry out more frequent risk-based on-site missions as an appropriate and cost-effective way to enhance the effectiveness of supervision. Finally, staff indicated in ¶36 that “potential impact of AML/CFT risks on the macroeconomy is yet to be quantified”. Could staff clarify why such an exercise has not been conducted?

Finally, we would have appreciated a fresh assessment of Estonia's digital transformation in terms of savings for the government, impact on the technology industry, inclusion and results of the digital residency program.

With these comments, we wish the authorities every success.

Mr. Raghani, Mrs. Boukpessi and Mr. Ondo Bile submitted the following statement:

We thank Staff for the insightful reports and Mr. Ostros and Mr. Vaikla for their informative buff statement.

Estonia’s economic performance has been robust in recent years thanks to sound macroeconomic policies and far-reaching structural reforms. Growth has been solid above potential, albeit declining in 2019. The fiscal and external positions remain strong. Notwithstanding these developments, Estonia faces long-term challenges with weak productivity, rigidities in the labor market, and aging population. Looking ahead, although positive, the macroeconomic outlook is subject to downside risks steaming from unfavorable global conditions, weak competitiveness and cross-border financial risks. Against this backdrop, we see merit on the need for more growth friendly fiscal policy, further enhancing the ongoing structural reforms with a focus on raising productivity and addressing inequality while taking necessary steps to tackle potential risks to the financial sector stability and furthering progress in strengthening the AML/CFT framework.

Sound and sustainable fiscal policy has served the country well and provided macroeconomic stability. Estonia has maintained a strong fiscal stance, creating large fiscal buffers, and the gross public debt is the lowest among EU at 8 percent of GDP, and is expected to decrease further by 2023. Over the medium-term, we agree with staff on the need to consider progressively relaxing the recent years' fiscal stimulus, and further promote growth-friendly measures, including by increasing productive investments in infrastructure, education, health and innovation, as well as enhancing labor supply. Measures to contain the public wage growth are also warranted. We urge the authorities to make strides in implementing the 2018 PIMA recommendations for an improved and efficient public spending and strengthened public investment management. Given the macroeconomic implications -higher healthcare and pensions costs - of the demographics changes as highlighted in Annex VI of the report, we encourage a prudent approach in reviewing the current pension system – Pilar II - with the view to maintain its social viability and sustainability. Could staff elaborate on how Estonia's pension system compares with its EU peers and more broadly to similar countries with aging population?

The banking system in Estonia remains sound although emerging vulnerabilities need to be addressed. The banking sector is overall solvent, with high liquidity ratios and low NPLs. However, with short to medium-term risks to the financial sector assessed as moderate, we encourage the authorities to pay closer attention to potential vulnerabilities that could arise from the financial and housing market developments associated to large Nordic financial institutions. We welcome the macroprudential measures already taken to mitigate those risks, notably the systemic risk buffer requirement and the average risk floor for mortgage loans. We note the recent improvement in strengthening the AML/CFT regime. However, more remains to be done and we urge the authorities to take the necessary steps to swiftly address the shortcomings and reinforce the effectiveness of the framework, including by conducting more on-site AML/CFT inspections, and setting up discouraging fines, as recommended by Staff. In this context, we look forward to the conclusions of the forthcoming MONEYVAL assessment. Could staff indicate when this assessment is expected to be finalized?

Advancing structural reforms is key to boosting productivity and strengthening inclusive growth. We concur with staff's call for an increase in R&D's spending to enhance innovation and welcome programs such as the

"Estonia 2020" reform strategy aimed at mitigating labor skills mismatches and removing productivity weaknesses. Also, we welcome ongoing measures highlighted in Mr. Ostros and Mr. Vaikla's buff statement aimed at promoting adults' access to formal education and in-service training among other actions taken to mitigate remaining gaps in the labor market. Additionally, reforms efforts should target further reduction of income inequality and incident of poverty especially among women and elderly population. To improve competitiveness, Estonia could further reinforce its participation in Global Value Chains, as noted in Selected Issues Paper.

With these remarks, we wish the Estonian authorities, every success in their endeavors.

Mr. De Lannoy submitted the following statement:

We thank staff for their clear and insightful report and selected issues paper in the context of Estonia's Article IV consultation. We also thank Mr. Ostros and Mr. Vaikla for their informative buff statement.

The strong economic performance of Estonia in the past few years and the sizable fiscal space provide strong grounds to successfully tackle structural challenges and unlock the full growth potential. We welcome that staff and the authorities broadly agree on the needed reforms which should focus on boosting productivity, reducing inequality and further strengthening the AML/CFT framework. We share this view and would further highlight the need for ensuring the adequacy and sustainability of the pension system and for vigilance in monitoring housing market developments. We take note of the challenges posed by demographic developments.

Macroeconomic developments

The Estonian economy continues to enjoy a strong performance, displaying robust growth figures and historically low unemployment rates, but begins to slow towards its potential. Economic growth is expected to moderate over the next years with a cooling off in inflation and possibly also wage dynamics. The buff statement already notes signs of a turning point in the labor market. We share staff's view that short to medium-term risks stem from both external and domestic developments. With regards to the latter, continued strong wage growth, exceeding productivity developments, might curb competitiveness and exacerbate medium-term risks; while AML/CFT concerns, if unaddressed, might affect the banking sector.

Fiscal policies

Both staff and the authorities estimate a withdrawal of fiscal stimulus in the near term, that is fully in line with EU recommendations and is appropriate in view of the positive output gap. Very low government debt levels and the prudent deficit path provide a substantial fiscal space, over the medium- to long-term, that should be used for boosting investments. Over the medium term, substantial fiscal space exists both vis-à-vis the minimum structural balance that Estonia needs to maintain and its very low debt-to-GDP level which, at 9 percent of GDP, is the lowest in the euro area. Given the small and open nature of Estonia's economy, which exposes the country to a number of downside risks, including trade and geopolitical tensions, we welcome the generally prudent policy approach taken by the authorities. At the same time, we agree with staff that available fiscal space should be devoted to productivity-enhancing investments and a strengthening of the social safety net over the medium-to long-term. In this context, we welcome that the authorities are formulating a joint strategy for R&D, innovation and entrepreneurship but also note that public spending on these objectives is appreciably lower than the government's long-term target while there is also a risk of reduction in EU funds available for investments.

We broadly support staff's analyses and conclusions regarding the planned changes to pillar II of the pension system and its mandatory nature. As staff highlight, the adequacy of pensions is a main concern that is reflected in high relative poverty of the elderly. The proposed changes to pillar II risk aggravating the low adequacy of pensions in the longer term and, coupled with unfavorable population trends, imply increasing pressures on public finances.

Financial sector policies

The banking sector in Estonia remains overall sound but risks stemming from the housing sector should be monitored closely. Banks are profitable and well-capitalized, which limit risks to financial stability. We note that concentration in the banking sector has been high, as three largest banking groups are foreign and hold 80 percent of banking sector assets. We therefore welcome the extensive Nordic-Baltic cooperation of financial supervisors that should contribute to better preparedness and reduced risks to financial stability. While housing prices are in line with fundamentals, Estonia has been experiencing persistently high household credit growth (around 7 percent annually) and residential real estate price growth (8.5 percent on average over the last 8 years) in recent years. The introduction of the average risk weight floor of 15 percent and the countercyclical capital buffer at zero seem appropriate. Nevertheless, macro-financial developments should continue to be carefully monitored.

We welcome the notable improvements in the AML/CFT regime of Estonia, as evidenced in the report. The share of non-resident deposits has declined substantially since 2017 as the institutional and legal provisions to prevent money laundering were tightened. However, continued reform and enhanced monitoring will be critical to mitigate evolving risks in this area and to safeguard the integrity and resilience of the banking sector. We take positive note of the authorities' intention to further increase the resources available to the relevant agencies and of the draft legislation transposing the EU Anti-Money Laundering Directive.

Structural policies

Boosting productivity to preserve competitiveness and tackling inequality are two of the main structural policy priorities. The strong wage growth in recent years has persistently outpaced productivity growth, thus raising concerns about competitiveness. Adverse demographic prospects could pose further threats in the medium term. Increasing R&D expenditure, addressing the skill mismatch, promoting more decisively life-long learning and vocational education, are all suitable measures to address productivity problems. As regards labor market functioning, we share staff's conclusions about the need to improve the balance between flexibility and social security. We consider the Work ability reform as a step in the right direction and support the ongoing review of the unemployment insurance scheme. Notwithstanding recent improvements, inequality in Estonia is still above the EU average while the relative poverty rate and the gender pay gap are both among the highest in the EU.

Mr. Psalidopoulos and Ms. Cerami submitted the following statement:

We thank staff for the comprehensive set of papers and Mr. Ostros and Mr. Vaikla for their helpful buff. Estonia has experienced robust economic growth with large gains in employment and income, supported also by sound policies. However, as a small open economy with a declining and aging population, more efforts are urgently needed to boost productivity, preserve external competitiveness, and address unfavorable demographic trends. We broadly agree with staff's assessment and policy recommendations and associate ourselves with Mr. De Lannoy's statement. We therefore will limit our remarks to the following specific points for emphasis.

Fiscal stimulus should be removed in the short term, while increasing productivity-enhancing investments. We concur with staff's assessment, shared by the authorities, that with economic growth above potential and low interest rates, the fiscal policy stance should turn neutral by containing current expenditures. In this regard, we support staff's call for a moderation of public sector wages, which have grown faster than private sector wages and productivity, with detrimental effects on competitiveness. At the same time, with the lowest public debt to GDP ratio in the EU, we encourage the authorities to increase productivity-enhancing investments, particularly in R&D, which is still below the target of 1 percent of GDP. Furthermore, given Estonia's large oil shale reserves, we see merit in focusing R&D investment in the energy sector to support the transition to renewable energy production and cleaner oil shale technology. In this regard, we would encourage staff to elaborate further on the implications of the EU 2020 strategy for a low carbon Europe by 2050 in the next Article IV Consultation.

Further structural reforms are needed to reduce inequality and address demographic challenges. We commend the authorities for the successful implementation of work ability reforms and for easing restrictions on foreign labor, which have increased labor force participation. The labor supply has also benefited from the personal income tax reform, which has lowered the tax wedge for low-income earners, providing stronger incentives to work. However, more could be done to boost the labor supply and reduce income inequality, including through streamlining unemployment benefits, integrating more foreign workers, upgrading training, and expanding childcare benefits. We agree with staff that reducing inequality will also require measures to close the large gender pay gap and increase the low replacement rate of pensions. At the same time, we share staff's concerns about the proposed changes to the second pillar of the pension system, which could negatively impact on income inequality, financial stability, and capital market development, and undermine the system sustainability.

Financial authorities should continue to closely monitor emerging risks. We take positive note that current macroprudential measures are assessed as appropriate and encourage the central bank to continue closely monitoring emerging risks, particularly in the housing sector, and taking prompt action, such as the recent introduction of an average risk weight of 15 percent on the mortgage loans of the two systemic banks. We also welcome the significant progress in strengthening the AML/CFT regulatory and supervisory regime following the cases of some Nordic banks operating in Estonia and encourage the authorities to make further progress along staff's recommendations, in preparation of the next MONEYVAL assessment planned in 2022.

Mr. Merk and Ms. Koh submitted the following statement:

We thank staff for their informative set of reports and Mr. Ostros and Mr. Vaikla for their insightful buff statement. We associate ourselves with the statement issued by Mr. De Lannoy. In addition, we offer the following comments and questions for emphasis.

Estonia's macroeconomic outlook remains robust with strong growth driven by private consumption and growing investment. The banking sector is overall solidly positioned and the authorities have fiscal space, should a downturn occur.

We would like to highlight Estonia's impressive convergence process within the euro area since 2011, fostered by the authorities' commendable policy track record. At the same time, there are downside risks particularly relevant for Estonia's small open economy. On the external side, slowing exports to main trading partners reflect increasing trade tensions on a global scale. At the domestic level, labor shortages and related wage pressures pose a risk to Estonia's competitiveness. Moreover, macrofinancial risks require close monitoring. Regarding the medium-term outlook, we wonder if the projected growth rates of potential output of at least 3.5 percent until 2023 may be overly optimistic given the presently already materializing decline in the working population. We would welcome additional staff comments on this issue.

Enhancing labor productivity is key to maintain competitiveness. Wages have continuously risen more strongly than productivity in recent years. Against this backdrop, we second staff's concern about a possibly problematic demonstration effect of large increases in public sector wages on overall wage growth. That said, we acknowledge the determined policy responses of the Estonian government in the course of the 2008 / 2009 recession. Estonia has implemented various anti-crisis measures which included major reductions in public sector wages to tame growing expenditures. These policy decisions where essential to safeguard the fixed exchange rate regime to the Euro and to preserve the gains from Estonia's structural economic transformation paving the way to EU accession and adoption of the Euro in 2011. Wage flexibility has been a decisive factor that has contributed to Estonia's impressive recovery in the following years.

Given the fact that Estonia's economy is currently operating above its potential, as well as the expansionary monetary policy environment for Estonia, we see the authorities' case for a continued tightening of the fiscal stance. We note that the expected improvement in the structural deficit will be rather gradual (0.1 - 0.2 PP this year). Well-targeted investment in R&D as well as structural reforms, such as the modernization of the insolvency framework, seem appropriate to boost productivity and innovation.

Estonia is facing a decline in population, with repercussions not only on the economic and fiscal, but also on a social scale. In light of the already relatively high share of elderly population at risk of poverty, we share staff's concern about the pension system's currently relatively low replacement rate. Staff rightly highlights the difficult trade-offs between the need to safeguard the social viability of the overall pension system as well as avoiding unsustainable fiscal costs. Against this backdrop, we see merit in staff's arguments (including the worry about short-term macroeconomic volatility) in favour of maintaining the second pillar of the pension system as mandatory A well-designed pillar II can indeed play an important, complementary role in making the overall pension system socially and fiscally more sustainable.

In the wake of recently detected money laundering cases, the authorities have taken manifold steps to strengthen AML/CFT supervision, resulting in a marked decline of non-resident activity. We positively note the authorities' and staff's agreement on additional measures at the domestic level. Taking into account the cross-border nature of money laundering, we would also like to stress the importance of ongoing work at the EU level including a higher level of harmonization of rules and regulations in this area, as laid out in the Document of the Council Conclusions (ECOFIN) from its meeting held on 5 December 2019.

Mr. Buissé, Mr. Rozan and Ms. Gilliot submitted the following statement:

We thank staff for their very interesting set of documents and Mr. Ostros and Mr. Vaikla for their informative buff statement. We broadly share the thrust of the report and concur with staff on the good performance of the Estonian economy fueled by private consumption, investment, favorable market conditions and a high integration in Global Value Chains (GVCs). Although price competitiveness developments point to a decline in competitiveness, Estonia's external position remains strong. The country's ample fiscal reserves allow for higher spending in key growth-enhancing areas including R&D, health, education and infrastructure, which are key to ensure higher productivity growth. Sustained momentum on structural reforms will also be key going forward, to support labor supply, reduce inequality and poverty and modernize the insolvency framework. We associate ourselves with Mr. De Lannoy's statement and would like to provide some additional remarks.

Outlook and risks

The Estonian economy keeps performing very well, though domestic and external imbalances poses risks ahead on future growth and competitiveness. The country's substantial fiscal space and large current account surplus provide useful buffers against the risks highlighted in the report, in particular a possible escalation of trade tensions, tighter financial conditions, and labor shortages. The Selected Issues Paper on Competitiveness and GVCs was particularly insightful, and we do share its conclusion regarding competitiveness issues in Estonia. In line with staff's recommendations, we encourage the authorities to address the misalignment of wage and productivity growth which may hamper in the medium-term the country's competitiveness and exacerbate imbalances.

We welcome the update of Estonia's external position presented in Annex III of the report which nevertheless raises some questions. We understand that the CA model is often more informative and reliable than the REER index model. However, CA and REER gaps should be consistent, reflecting in the case of Estonia, its income convergence, the rise in ULCs, adverse demographics and a loss of competitiveness. Since both CA norm and EBA-lite REER methodologies result in sharp differences, to a negative and positive REER gaps respectively, we were wondering if providing ranges for the CA and REER gaps wouldn't be more consistent to accommodate uncertainties in these assessments? Staff's comments are welcome.

Fiscal policy

The positive fiscal stance should be used adequately to improve macroeconomic conditions and to boost productivity through consistent investment and innovation policies. Estonia has ample leeway to use its fiscal space to help address both internal and external imbalances. As a result, fiscal policy should be reoriented towards innovation, R&D, investments in infrastructures, education and health and prepare for adverse consequences of an ageing population. Given the challenges the country faces, its significant current account surplus and ample fiscal buffers, could staff elaborate on their recommendations to unwind the expansionary fiscal policy in the near term? We share staff's call to reorient the composition of spending towards growth enhancing spending, such as R&D investment. In this respect, the Public Investment Management framework should be further strengthened. On the tax side, measures including the reduction or non-taxation of reinvested profits in R&D and digital technologies would help bolster investment in new technologies and incentives for innovation. Staff's comments on this issue would be welcome.

Fiscal policy has a greater role to play to support a more inclusive growth and reduce poverty and inequality as underscored rightly in the Selected Issues Paper. The pension system should be reviewed in light of these considerations with greater scope given to increasing net returns and preventing poverty among the elderly. We share staff assessment that maintaining the mandatory nature of Pillar II would be important.

Financial system

The banking sector is healthy, profitable and risks arising from housing sector are contained. However, its high interconnectedness with the Nordic-Baltic region warrant tight supervision and control of ML/TF risks. We thank staff for the Selected Issues Paper's detailed analysis of the AML/CFT supervisory framework and strongly support the main recommendations including the enhancing of the implementation of the risk-based approach to AML-CFT supervision and of the supervisor EFSA' powers and enforcement toolkit. We welcome the strengthening of the information sharing and coordination of AML/CFT supervision activities. The creation of a permanent working group of Nordic-Baltic financial sector supervisors as well as the conclusion of MoU with non-EU supervisory authorities are really encouraging and should give an impetus to stronger integration/consolidation of AML/CFT supervision at the EU or Nordic-Baltic levels. We look forward for the conclusions of the 2021 Moneyval assessment to show significant progress made in addressing the deficiencies identified of the legal framework.

Structural reforms

Considering global uncertainties and growing downside risks, raising productivity is paramount, tackling in particular labor market rigidities and upgrading innovation and education policies. The implementation of the "Estonia 2020" reform strategy is commendable, and we encourage the authorities to proceed further and better integrate training, skill enhancements and innovation into the R&D strategy. Labor supply shortages should be addressed by improving foreign workers and female labor participation, reduce inequality and gender pay gap. The on-going work reviewing eligibility and increasing the flexibility of the unemployment insurance system is welcome. Remaining drags on productivity need to be removed to allow efficient reallocation of resources to (new) productive areas. Along with higher investment in innovation and R&D, more emphasis should be put on improving insolvency proceedings and heighten the debt restructuring framework, thus freeing financial capital to innovative programs.

Mr. Just and Mr. Mehmedi submitted the following statement:

We thank staff for the insightful reports, and Messrs. Ostros and Vaikla for their in-depth buff statement. Estonia has strong fundamentals and a favorable medium-term outlook. However, with external and domestic risks tilted to the downside, as well as demographic challenges, the authorities should continue with prudent fiscal policies, address financial sector risks, and advance the implementation of the structural reform agenda to improve productivity, safeguard competitiveness, and secure a faster income convergence with the EU. We broadly share staff's assessment and advice and associate ourselves with the statement by Mr. De Lannoy.

The existing fiscal space should be deployed to boost medium-term growth, enhance social cohesion, and reduce inequality, coupled with reforms aimed at improving the structure of the budget. We commend the authorities for their prudent fiscal policies which have resulted in very low gross public debt, ample fiscal reserves, and considerable fiscal space. Considering the positive output gap, we concur that the authorities should unwind the positive fiscal impulse in the short term to guard against potential overheating. Concurrently, the existing fiscal space should be used over the medium-term to support growth and investments while reducing inequality and poverty. To this end, we encourage the authorities to rationalize unproductive current spending while strengthening the supply side of the economy through higher financing of the active labor market policies (ALMPs) and innovation programs, and the health and education sectors, as well as further reducing the high tax wedge. Improving the efficiency of public spending will also require strengthening the public investment management, including the implementation of the recent Public Investment Management Assessment recommendations on the planning, allocation, and implementation of investments. Against the backdrop of adverse demographic changes, the authorities should cautiously consider the prospective changes to the second pillar of the pension system, as it has served very well in supplementing the publicly managed and compulsory pillar I system.

Structural reforms should aim at tackling stagnant productivity and aligning wage growth to productivity dynamics. We note that productivity growth in Estonia has slowed, despite the sizeable productivity gap with EU, while wages have been rising rapidly, increasing unit labor costs beyond those of its EU peers. Indeed, the persistent divergence between wage growth and productivity growth could, over time, adversely impact competitiveness and undermine convergence. Against this backdrop, the authorities should take measures to align wage growth in the public sector to the overall productivity dynamics by enhancing government representation in wage negotiations, while increasing productivity through innovation. Additionally, there is a need to increase the labor supply through strengthening the disability program, improving ALMPs, streamlining unemployment benefits, reducing constraints to migration, and boosting the labor force participation of young women through extending the availability of childcare. Staff’s comments on whether the authorities are considering relaxing the immigration quotas for non-EU and non-EEA countries are welcome.

The shortcomings of the AML/CFT framework should be urgently addressed. We welcome that the banking sector remains profitable, liquid, and solvent, but note that the exposure to predominantly Nordic parent banks requires further strengthening of cross-border cooperation with home country authorities. In view of the money laundering (ML) incidents, the authorities should urgently take action to further strengthen the AML/CFT framework, including by transposing the relevant EU legislation, along with conducting a new national risk assessment in order to have more risk-based and thematic AML/CFT inspections and increasing the number of on-site inspections. In addition, strictly implementing and imposing higher monetary penalties for ML violations would contribute to a more effective AML regime. While we welcome the planned assessment of the AML/CFT regime by MONEYVAL in 2022, in light of AML/CFT vulnerabilities, we wonder whether there is flexibility to bring the assessment forward and would appreciate staff’s comments whether focusing solely on Estonia is sufficient. Although real estate market activity has moderated and prices seem to be anchored by income, those indicators appear to be high compared with peers, we encourage the authorities to continue to closely monitor the macro-financial and housing risks, while enhancing the macroprudential toolkit and using the different macroprudential measures to prevent and mitigate risks to the financial system.

Mr. Moreno and Mr. Montero submitted the following statement:

We thank staff for its informative reports and Mr. Ostros and Mr. Vaikla for their useful buff statement. We broadly share staff's appraisal and associate ourselves with Mr. De Lannoy's statement. We offer the following comments to emphasize some specific issues.

The Estonian economy has performed quite well in recent years, with robust growth, rising wages and falling unemployment towards record lows, supported by prudent macroeconomic management and effective structural reforms. Indeed, substantial fiscal space, current account surpluses, and a strong macroprudential framework provide important buffers going forward.

The authorities seem to be facing a conflict between the economy's needs in the short- vis-à-vis the long-run. Over the near term, as the economy appears to be operating above potential and the monetary policy stance is very accommodative, we share staff's view that the positive fiscal impulse should be wound down. From a longer-term perspective, given declining productivity growth and demographic challenges, the substantial fiscal space should be used to enhance potential growth along the lines suggested by staff. Moreover, lingering poverty and inequality issues would warrant the deployment of a share of that space to ensure a socially sustainable pension system and improve the social safety net.

Related to the previous points, we would like to note that there are no relevant inflationary pressures and real output is still about 10 percentage points (pp) below the counterfactual level implied by the pre-crisis average trend, which contrasts with staff's estimates of the output gap of about 2 pp. In this context, which is shared by several other economies, there is a debate on whether there is a case for running on a high-pressure economy to continue to undo the persistent damage from the global crisis. As shown by the recent US experience, this option would have the additional advantage of benefitting more the most disadvantaged workers through stronger wage growth and better jobs, thus contributing to mitigate inequality. Staff's comments are welcome.

Regarding structural reforms, as shown in Annex VI, policies aimed at offsetting the expected labor force decline due to ageing can only reduce, but not reverse, the decline in labor supply, particularly the increase in the statutory retirement age. Thus, it becomes essential to boost productivity growth. In the case of Estonia, a relatively flexible economy where the business environment is favorable, there are no obvious low-hanging fruits, so it is more difficult to identify the most binding constraints. Incentivizing R&D and innovation activities seems like a sensible recommendation. However, it lacks an enough degree of granularity. We encourage staff to dig further into this topic going forward. Does staff see a role for some type of industrial policy in the Estonian case?

The gender pay gap is very high, despite successful efforts to foster higher female participation rates. We take note of staff's recommendation to extend the availability of childcare to incentivize full-time employment, but wonder whether this is enough given the magnitude of the problem. We welcome the authorities' efforts to diversify electricity supply by investing in renewables and cleaner shale oil technology, which will be important to tackle CO2 emissions and to contribute to a low carbon Europe.

Finally, we concur with staff on the need to continue enhancing the AML/CFT regime by ensuring timely and dissuasive fines, increasing the number of on-site inspections and considering the introduction of supervision at the regional level (including supra-national entity at the EU level).

The representative from the European Central Bank submitted the following statement:

We would like to thank Mr. Ostros and Mr Vaikla for their buff statement and Staff for their report. We associate ourselves with the statement by Mr De Lannoy and would like to further highlight a few issues.

We share the positive IMF staff assessment about developments of the Estonian economy in 2019 and about the downside risks to the outlook from external and domestic developments. The Estonian economy continues to enjoy a strong performance, displaying robust growth figures and historically low unemployment rates. However, in line with the latest industrial production figures and confidence indicators, economic activity is expected to moderate over the next years, with real GDP growth rates close to 3 percent, thereby converging to its potential rate of growth. Regarding HICP inflation, we also expect a slowdown over the forecast horizon. Nevertheless, short to medium-term risks might stem from both external and domestic developments. Being a small, open economy, Estonia could significantly suffer from a further escalation of geopolitical and/or trade tensions. In addition, a possible tightening in financial conditions in other Nordic economies could negatively affect the country. On the domestic side, continued strong wage growth, decoupled from productivity developments, might curb competitiveness and exacerbate medium-term risks. Furthermore, AML/CFT concerns if unaddressed, and possible adverse effects following weaker growth might affect the banking sector and keep the domestic risks tilted to the downside.

We broadly agree with the IMF staff analysis of the financial sector and macroprudential policies in place, and would like to raise some additional points. In line with Staff views, Estonia has been experiencing persistently high household credit growth and residential real estate (RRE) price growth in recent years. Annual growth in bank loans to the household sector stood at 6.8 percent in Q2 2019, and has been at similar levels over the last two years. At the same time, annual RRE price growth has been buoyant at 8.5 percent on average over the last 8 years. Strong wage growth is supporting demand for household loans. Additionally, we point out that household indebtedness measured as credit-to-GDP ratio continues to be elevated compared to regional peers with similar income levels, although household loans have remained steady at just below 40 percent of GDP. Therefore, the effectiveness of macroprudential measures affecting RRE (RRE risk policy measures, including the newly introduced risk-weight floor) should be carefully monitored to ensure that risks are contained. The key priority going forward is to ensure appropriate lending standards to households as failure to do so could reinforce credit and house price spirals. At the same time, cyclical risk has declined and the countercyclical capital buffer is appropriately set at zero. However, macro-financial developments should continue to be carefully monitored, also due to the risk of spill-overs from other sectors (e.g. residential real estate and household sectors).

We welcome the notable improvements in the AML/CFT regime of Estonia, as evidenced in the report. We also take note of the IMF staff assessment that continued reform and enhanced monitoring, including AML/CFT supervision, will be critical to mitigate the evolving risks within the AML/CFT regime. Weaknesses in the AML/CFT framework represent a risk to the integrity and resilience of the banking sector. The measures taken after the major money laundering incident suggest that the country has recorded notable improvements in the AML/CFT regime. In the same vein, continued reform and enhanced monitoring will be critical to mitigate evolving risks in this area.

On the fiscal front, Estonia has persistently secured a solid stance, with fiscal vulnerabilities pertaining towards the longer-term. Estonia’s sound fiscal policies have shielded the country from sustainability risks and provides significant fiscal space. To note, in 2018, Estonia had the lowest debt-to-GDP ratio among the countries in the euro area. Estonia’s current level of government debt and the government's plans to achieve a balanced structural balance in the short run, place the country well within the boundaries of the Stability and Growth Pact. Against this backdrop, it would be advisable to use the available fiscal space to foster productivity-enhancing reforms, aimed at increasing the workforce participation and investment in R&D, and to strengthen the social safety net. Fiscal vulnerabilities are mostly of a long-term nature. The current proposal for reform of the pension system involves voluntary participation in pillar II of the pension system. Coupled with unfavorable population trends, these developments imply increasing pressures on public finances and would increase long-term fiscal sustainability risks, which would need to be addressed.

We agree with Staff that boosting productivity to preserve competitiveness and tackling inequality, along various dimensions, are two of the main structural policy priorities. Accelerating productivity growth is a priority to preserve competitiveness. The strong wage growth in recent years has persistently outpaced productivity growth, thus raising concerns about competitiveness. In this respect, the adverse demographic prospects pose further threats in the medium term. Increasing R&D expenditure, addressing the skill mismatch, promoting more decisively life-long learning and vocational education, are all suitable measures to address productivity problems, as highlighted by IMF staff.

In addition, we would like to highlight the importance of digitalization and possible risks to investment from a reduction to EU funds. Along with the actions recommended in the report, the potential positive impact of digitalization on productivity should also be considered. Indeed, despite displaying unrivalled digitalization performances in the public sector, Estonia's private sector still lags behind. Thus, an improvement of the latter might contribute to raising productivity. Second, there is a risk that the EU 2021-2027 Multiannual Financial Framework might follow different allocation criteria with respect to the past, thus putting Estonia at risk of facing a reduction of EU funds, thereby leading to a widening investment gap. This risk reinforces the Staff recommendation to increase domestic investment.

The Acting Chair (Mr. Zhang) made the following statement:

The Estonian economy has been performing well in recent years, growth has remained strong. The near-term outlook is also favorable, but medium-term challenges remain. There is a need to push forward further the reforms aimed at addressing these challenges, particularly the structural mismatches, including in the labor market.

The staff representative from the European Department (Mr. Gueye), in response to questions and comments from Executive Directors, made the following statement[1]:

I would like to thank Directors for the rich comments that were provided in the gray statements. My team and I have endeavored to provide comprehensive responses to the questions you raised. Therefore, I will limit my intervention today to three recurring themes related to fiscal policy, pension system challenges, and the financial sector.

Let me begin with the fiscal policy. There was broad interest in our call for unwinding the fiscal impulse that had been accumulated in recent years. We are of the view that with the positive output gap and in the context of a low-interest environment, there is a strong case for unwinding the current expansionary fiscal stance in the short-term. However, in the longer-term, we recognize the need to use the substantial fiscal space to enhance policies geared to raising productivity while addressing external imbalances. With a substantial fiscal space, Estonia has scope to use the fiscal policy in a more growth-friendly direction without the need of a sizeable consolidation in the near term. This would be helpful to better address the infrastructure gap, low level of investment in research and development, and rapid population aging challenges.

To achieve this, we see scope to save more from recurrent expenditure, particularly wages, as growth has been higher in recent years. At the same time, ongoing public investment management reform should help to improve the efficiency of spending.

I now turn to my second point, which is pension system changes. Plans by the authorities to make the second pillar pension voluntary have offered a platform for increased collaboration with the Fund. In a bid to broaden the scope of consultation, I visited Estonia with a team of experts and participated

[1] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

in a workshop jointly organized by the central bank and the Fund. This workshop attracted different stakeholders who contributed to the dialogue. It became very clear during this consultative process that the pension system changes have become a focal point of the authorities. There was also an evident consensus on the need for improvement, given the modest return and improvable investment options.

Our conclusions were that despite the political mandate, the authorities should factor in the proposed changes, including the potentially destabilizing macroeconomic effect of allowing people to withdraw cash, which may undermine a still-developing culture of saving and long-term fiscal cost. In this regard, we share Directors' concerns about mitigating the effect of the impact as the changes are likely to go ahead. We see scope to mitigate the possible adverse effect by reducing the pace of the process, consulting widely, lengthening the minimum period for withdrawing the funds, ring-fencing shareholders that have invested into certain pillar pension fund, and ensuring that the requisite information technology infrastructure is ready to help make the transition seamless.

My last point relates to the financial sector. Overall, financial soundness indicators suggest that the health of the financial system is strong with banks retaining ample buffers. In this context, preventing money-laundering has become a priority for the region, including Estonia, against the background of recent allegations. Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) remains an issue which is being addressed by the authorities. They agree that one of the Article IV themes is to be centered on this issue and will work closely with colleagues from the Legal Department.

Like Directors, there is a lot of interest in the forthcoming assessment of MONEYVAL, which is expected to be conducted in 2021 and its publication in 2022. However, in line with our Selected Issues Paper (SIP) findings, Directors may seek comfort in the fact that there has been significant progress in strengthening the AML/CFT framework and supervision, and we are of the view that continued reform, especially for reinforcing cross-border supervision, will be critical to mitigate risk. In this context, we reiterated that the process to impose monetary penalties for violation of AML/CFT-related obligations need to be streamlined and the maximum penalty increased. Efforts should continue to increase the number of institutions that may be covered by inspection; to develop risk-based, targeted, and thematic AML/CFT inspection; and to further increasing resources.

I thank the authorities for their excellent collaboration and willingness to provide the necessary inputs to make comprehensive the set of papers presented to you. I also thank the Executive Director for Estonia for kindly accompanying us on mission and wish him all the best in his next challenges.

Ms. Riach made the following statement:

We welcome Estonia's strong economic performance underpinned by effective structural reforms and support staff's recommendations. I will focus my intervention on three points.

First, let me touch on the challenges facing Estonia's energy sector in light of the ongoing transition from oil to renewable energy. We take note of the government's plans to diversify electricity supply by investing in renewables and cleaner oil shale technology. We appreciate the scale of the challenge given the size of the energy sector relative to GDP. The transition to a greener economy will require coordinated effort between the public and private sector. In particular, the transition is likely to have implications for Estonia's financial institutions. Changes in the volume of investments held by banks and insurers in the oil sector is one example. We would be interested to know whether staff discussed these issues with the authorities and whether staff are planning to cover climate transition risks in more detail potentially through a stress testing exercise in the next Financial Sector Assessment Program (FSAP).

My second issue, we welcome the improvements to the AML/CFT regime, particularly sustained efforts by the Financial Supervisory Authority (FSA) to refine its off-site supervision, conduct full on-site inspections, and actively employ its enforcement powers. We also thank staff for the extensive analysis of the AML/CFT in the Selected Issues Paper, which we find very useful. We take note of staff's concern that the annual number of on-site inspections remains low and focused on higher-risk financial institutions, and we welcome staff's proposed solutions, in particular the less resource-intensive recommendation to develop risk-based, targeted, and thematic inspections.

Finally, like other Directors, we find the Selected Issues Paper on dimensions of inequality very interesting and the statistics on the gender pay gap striking. We support staff's recommendation for more transparency, including through a reporting policy for the gender pay gap. We also welcome the additional information provided by Mr. Ostros in the buff on plans to reduce the gap in the private sector. With this, we wish the authorities success in their future plans.

Mr. Alkhareif made the following statement:

We have not issued a gray, but we would like to take this opportunity to commend the authorities for the solid economic performance, very low unemployment, and strong fiscal position. We note from the staff report that the economy is overheating, and the GDP is operating above potential. Given the available fiscal space, we see room for the authorities to focus the spending on improving the infrastructure productivity, as well as research and development, and we take positive note of the mention of Mr. Ostros that the authorities are keen to focus on these issues. We welcome also the efforts to improve spending efficiency, which is important.

On labor force participation, I take positive note of Mr. Ostros' mention that the country is one of the highest in terms of labor force participation in the European Union. This is, indeed, encouraging, and I think it provides a good experience to other countries on how to improve labor market participation, especially for women. At the same time, we note from the Selected Issues Paper that the gender wage gap is big in the country. We welcome the emphasis that the structural reforms could be implemented to address the wage gap in the country. We particularly note that 80 percent of the gender pay gap is unexplained, and this poses a puzzle not only for the IMF but for the authorities themselves on how to tackle these issues. I appreciate the mention that the Ministry of Finance is doing an effort to collect the needed data to help policymaking in this area.

On financial sector policies, we welcome the efforts to improve the AML/CFT framework and encourage the authorities to continue the efforts in this important area.

Finally, I would like to express my appreciation and the Saudi office's appreciation to Mr. Ostros high added value in the Board, including in countries in his constituency. With these remarks, I wish Mr. Ostros and all colleagues in his office all the best in their future endeavors and the new job with Mr. Ostros.

Mr. De Lannoy made the following statement:

Estonia's economic performance has been strong, and sound governance has provided the country with robust fundamentals on which longer-term reforms can be built. Given the small and open nature of Estonia's economy, which exposes the country to a number of downside risks including trade and geopolitical tensions, we welcome the overall prudent policy approach taken by the authorities. Further raising potential growth and addressing demographic challenges are two major long-term issues that Estonia should consider addressing at this point. We have found staff's analysis and recommendation in this regard to the point.

Regarding fiscal policy in the short-term, staff and the authorities agree on the need to withdraw stimulus. Over the medium to longer-term however, like staff, we would emphasize the need to use the available fiscal space to increase investments and boost potential growth.

Demographic challenges, including a rapidly aging population and high relative poverty among pensioners, put a premium on carefully calibrating the pension system so that it meets both sustainability and adequacy requirements. We thus support staff's analysis and conclusions regarding the planned changes to Pillar II of the pension system and its mandatory nature.

Mr. Trabinski made the following statement:

We commend the authorities for their long track record of good reforms and prudent policies, which had an overall positive effect on the economy. Going forward, it seems that the authorities will have to focus more on the long-term perspective. This would need to include actions taken both on the structural and policy side to lift potential growth and address approaching demographic challenges. In addition to our statement and being in line with the outcomes of our Board retreat, let me emphasize just one point today.

The long-term challenges that are ahead for Estonia will require a different set of policies that have to be sustained over a protracted period of time. Staff's recommendation to increase productivity-enhancing spending and capital and infrastructure investment, coupled with a growth-friendly fiscal stance, strikes the right balance in terms of policy advice. However, we think that more can be done to address these challenges, specifically through small and medium-sized enterprises that would generate the vast majority of value added and employment in Estonia. It seems that this segment has substantial room to increase investment in innovation and skills, but this would probably require policies to breach the financing gap reported by small and medium-sized enterprises (SMEs). We would appreciate staff's view in this regard as we did not find much on this issue in the report.

We would also be interested to know whether the Estonian businesses in the fields in which Estonia has a strong comparative advantage, like digital, have the necessary potential to be scaled up regionally.

As this is the last Board meeting for our colleague, Thomas, let me take this opportunity to thank him for an excellent job he had done both as the Executive Director and as a friend. The commonsense that you brought to this Board will be very missed, Thomas. With this, let me wish the Estonian authorities and Thomas all the success in future endeavors.

Mr. Just made the following statement:

We thank staff for the answers to our technical questions and share Mr. De Lannoy's earlier remarks. We agree with Mr. Merk that Estonia's convergence with the euro area is rather impressive. Notwithstanding this convergence success, income inequality and poverty remain elevated, as well as structural impediments, including low productivity and adverse demographics weighing on the medium-term growth. To this end, continued commitment to sound fiscal policy and acceleration of structural reforms should remain important priorities going forward. In this context, we also encourage the authorities to address weaknesses to the public investment management framework and to implement the Public Investment Management Assessment (PIMA) recommendations.

The recent money-laundering incidents highlight the need for a strong and effective money-laundering regime. We acknowledge the efforts of the authorities to date to contain the fallout for Estonia's otherwise excellent governance reputation. We stress that cooperation with the relevant home authorities to strengthen the particular banks' internal money-laundering processes is necessary, as is the sharing of AML-critical information among financial intelligence units. In view of the cross-border dimension of AML, we highly welcome current work by the European Union (EU) on the possible centralized AML supervisor with EU-wide authority.

Mr. Heo made the following statement:

First, Estonia presents an interesting case of a developed country with high income levels, a small population, high measures of human development for health, education, and civil liberties; and it is a very highly digitalized society. Estonia faces a number of challenges, including an aging population, a tight labor market, and external pressures. The fiscal space it has should be used prudently to implement reforms that would address some of these challenges.

Second, as a highly digitalized country, Estonia is the first to hold elections over the internet and the first to provide e-residency. Like Mr. Jin and Ms. Zhao in their gray, also Mr. Trabinski this morning, we would be interested to know how this advanced digitalization status could be utilized and directed towards assisting Estonia in its economic development.

Finally, I would like to take this opportunity to thank Mr. Ostros for his time here as Executive Director. His comments have been one of the most insightful and succinct in the Board, which will be missed very much. Like others, I wish him all the best.

Mr. Anwar made the following statement:

First, tackling CO2 emissions and efforts to contribute to low carbon in Europe are warranted. We associate ourselves with Mr. Moreno and Ms. Levonian in their grays to welcome the authorities' plan to diversify electricity supply by investing in renewable and cleaner shale oil technology. Like Mr. Psalidopoulos, we also see merit in focusing in R&D investment in the energy sector to support the transition to a renewable energy production and cleaner oil shale technology.

Second, on competitiveness and global value chain (GVC), as well written in the Selected Issues Paper, like Ms. Levonian, we agree with staff and encourage the authorities to further deploy policies aimed at enhancing product sophistication for quality and export market diversification to mitigate Estonia's exposure to trade shocks in global value chains (GVCs). We associate ourselves with Mr. Buisse to support the authorities to address the misalignment of wage and productivity growth, which may hamper the country's competitiveness and exacerbate imbalances in the medium term.

Finally, we join other Directors to thank Mr. Ostros for giving such significant contribution to the Board for all Board meetings you have attended. We will miss your encouraging comments in the future. We wish you the very best for all endeavors.

Mr. Palei made the following statement:

Estonia is a very interesting country in which is the of case of “getting old before getting rich”, like some countries in Asia and a few countries in Eastern Europe. Thus, we could derive many useful lessons from the experience of Estonia.

The economy was growing at a relatively brisk pace, but now we see that there is a slowdown ongoing, and the estimates of potential growth are relatively low. The authorities themselves have it at 1 percent annually, and staff are a little bit more optimistic at 1.2, 1.3 percent. For some of the other countries, such growth rates are considered subpar and may be calling for additional reforms and additional energetic efforts trying to increase the rate of growth in the country.

It would be interesting to better understand what are the options for the authorities in Estonia to achieve higher growth rates, and here Mr. Moreno and Mr. Montero raised the possibility of designing some kind of industrial policy for the country so that the authorities can focus on the priorities in this area and have a comprehensive approach to engineer and continue to catch up with the eligible income in the euro area.

Here, I believe that the authorities are lucky that Mr. Ostros will have a new career in the European Investment Bank, since he worked with the authorities tirelessly over several years and even came here on the last day of his work at the Fund trying to better represent the Estonian authorities. I hope it is not a secret. I think Mr. Ostros will help the authorities to design the approach towards increasing potential growth through other means, not just macroeconomic stability and prudent macroeconomic policies, but also investments in infrastructure and investments, in many other projects that may help them to grow faster.

In the future reports, I would appreciate more attention to these issues and more analysis and comparisons with other countries with low interest rates, low debt, and, at the same time, trying to provide additional impetus to the economy through fiscal policy. Here I think there is room for additional research and we look forward to future reports on Estonia. I wish Mr. Ostros all the best in his efforts to improve the situation in Europe as a whole.

The staff representative from the European Department (Mr. Gueye), in response to questions and comments from Executive Directors, made the following statement:

> We agree on all the suggestions made by Directors. The questions reflect concerns and calling for moving ahead. I noted the question on the renewable energy issues, the small and medium enterprises, the opportunities they could provide, and the digitalization. Can it be used to leverage on productivity? Can it be used in order for an earlier cooperation among the countries in the region to move ahead?
>
> Regarding the renewable energy issue, we have noted the slow growth in 2019, given the importance of energy in the level of activity. We have met the main energy provider company and that is where we saw the impact of the decline in shale oil-based energy related to the increase of the price of the CO_2. There is new legislation across Europe, and as Estonia is incorporating it in its national legislation, the price of CO_2 has increased, which had an impact on the process of production.
>
> During the next Article IV consultation, we will take up the issues on renewable energy and its potential impact, but for this consultation there has not been a deeper discussion.
>
> For the small and medium enterprises, we agree that these enterprises could provide opportunities to increase the level of activity. They also have room to provide more job opportunities. Nevertheless, what the government can do is to provide a conducive environment. Estonia has one of the best business environments across Europe—I can say, even across the world.
>
> I think there are many areas that improvement can be explored. On the AML/CFT environment has to be improved as AML/CFT allegations could raise reputational issues and result in less attractiveness of the small- and medium-enterprise to investment or investment in general. The Article IV Report highlights improvements in the insolvency framework, which is a very important issue to resolve, and the authorities are drafting a new legislation framework to tackle this. It is also important to improve the infrastructure gap, as we underline in the report. This is the medium-term and long-term objective for the authorities. We believe that if all these areas are tackled by the authorities, it could result in an improved or enhanced business environment conducive for the development of the small and medium enterprises.

In terms of digitalization issues raised by many Directors, we tried to provide an initial answer. Estonia has an advantage related to digitalization. The Fiscal Monitor of April 2018 reflected how it has been used to enhance the efficiency of public operation, for instance, revenue collection. Estonia has one of the best collection processes in terms of revenue collection in terms of efficiency and the country leverage on digitalization. The fact that Estonia has an advantage on digitalization and weak productivity reflects that other factors have been at play, which adversely impact productivity. Among those factors, we noted the constrained investments in intangibles assets in distressed firms during the crisis and the slow capital technological change and the policy uncertain environment. We believe that those factors are still at play, and they constrain the full use of digitalization to enhance productivity. This is also an opportunity for collaboration among the Baltic countries and the countries in the region, and we welcome this issue. The Fund is doing work in digitalization, and it would be very good for staff to explore in what parameters a sound collaboration could be undertaken in order to provide a framework for these countries to use digitalization in improving productivity and economic activity.

Mr. Ostros made the following concluding statement:

Let me start by thanking the Article IV mission chief team, led by Ceikh Gueye, for providing valuable analysis and recommendations, the legal team for their comprehensive work, and Directors for their valuable interventions today, and thank you for your warm greetings.

The Estonian economy starts the new decade in a strong position with solid economic growth, prudent public finances, and one of the highest employment rates in the European Union. However, the authorities share staff's assessment that going forward, the challenge is to enhance potential economic growth in the context of long-term demographic and structural changes. As mentioned by Directors, the productivity performance has been rather weak and needs to be supported by productivity-enhancing investments. The government is committed to increase the share of R&D spending. Also scaling up public investment is on the agenda. Moreover, the Estonian government has identified climate issues as a political priority to contribute to a low-carbon Europe.

As Estonia is a small and open economy, vulnerable to external risks, the government remains committed to preserving sound public finances, which has served the country very well. The authorities agree with staff that with record low unemployment and a positive output gap, the current expansionary fiscal stance needs to be tightened. Over the medium to long term, the authorities aim to use the substantial fiscal space for productivity-enhancing investment and as a cushion against economic downturns.

Changes are currently planned to the second pillar of the pension system aimed towards increasing its flexibility and considerably increasing individuals' freedom of choice, not least when it comes to participation in the scheme. As underlined by several Directors, enabling individuals to opt out from the mandatory second pillar entails significant risks. The Central Bank of Estonia shares staff's view that participation in Pillar II must be kept mandatory to avoid destabilizing macroeconomic effects, increasing inequality, and higher fiscal costs over the long run.

The Bank of Estonia and IMF held a very useful pension workshop in September. The Estonian authorities would like to express their deep gratitude to the Fund's pension expert, Mr. Csaba Feher, for helping to organize the event and for his valuable and constructive policy recommendations. The risks to the financial sectors are low, as strong capitalization and profitability support the banking sector's resilience. The increase in housing prices has so far been in line with the strong growth in incomes, but the authorities are closely monitoring the situation and stand ready to take further measures if needed.

The authorities take it very seriously that the Estonian banking sector has been used for money-laundering. Forceful steps are being taken to improve prevention, increase fines, and by allocating additional funds to AML/CFT institutions. The authorities agree that full implementation of risk-based approach to AML/CFT supervision and increasing thematic on-site inspections as recommended by staff is essential. The interconnectedness of the Estonian banking system with the neighboring countries makes it important to cooperate closely with the authorities in the Nordic-Baltic region, including in the fight against money-laundering. Actions have been taken recently to further improve the already deep cooperation.

The labor market conditions call for high-quality labor market policies aimed to bridge skills gaps and increase labor productivity. The relatively high gender pay gap, as noted by many Directors, is a concern for the authorities, and a digital tool is planned to develop in order to substantially increase the wage market transparency and promote gender equality in the private sector.

Let me conclude once again by thanking the Article IV mission team for the constructive discussions with the authorities in Tallinn and the

Directors for offering valuable comments, which will be duly conveyed to the Estonian authorities. Thank you very much.

The following summing up was issued:

Executive Directors broadly agreed with the thrust of the staff appraisal. They commended the authorities for their economic management and structural reforms that have delivered solid economic performance in recent years. Noting the risks arising from the global trade and financial outlook, as well as demographic developments within Estonia, Directors emphasized that policies and reforms should focus on raising productivity, boosting sustainable growth and reducing inequality.

Directors generally called for unwinding of the expansionary fiscal policies in the short term. A few Directors, however, advocated greater emphasis on efficient spending. Over the long term, Directors supported using the substantial fiscal space for more growth-friendly reforms, in particular, to promote productivity growth and enhance labor supply.

Noting that monetary policy is likely to remain expansionary, Directors underscored that macroprudential policies should contain financial sector risks that could arise from the low interest rate environment. They encouraged the authorities to continue to monitor broader macro-financial developments, especially real estate and housing related risks, while enhancing the macroprudential toolkit and standing ready to act, should risks materialize.

Directors emphasized that accelerating ongoing reforms aimed at increasing productivity growth and boosting labor supply are important to raise long-term output. They highlighted that expanding firms' innovation capacity through more investment in research and development would broaden the economy's innovation base and enhance productivity. Directors also called for active labor market policies to support labor supply, particularly among low-income households. To further address inequality, they called for preserving the gains in labor force participation and employment over the last few years. Directors commended the reforms undertaken to increase female labor force participation and agreed that continued efforts to reduce the gender pay gap and further support childcare arrangements would be helpful.

Directors noted that Estonia's pension system plays a critical role in reducing relative poverty and, therefore, encouraged the authorities to preserve its viability and sustainability. They advised caution with regard to the changes being planned to Pillar II of the system as these could complicate macroeconomic management and further slow capital market development, as well as entail longer-term fiscal costs.

Directors welcomed the enhancements to the AML/CFT framework. They agreed that increasing the number of on-site AML/CFT inspections, raising the penalties for AML/CFT violations, and consolidation of supervision at the regional level would contribute to strengthening the AML/CFT regime.

It is expected that the next Article IV Consultation with the Republic of Estonia will be held on the standard 12-month cycle.

APPROVAL: May 19, 2020

JIANHAI LIN
Secretary

Annex

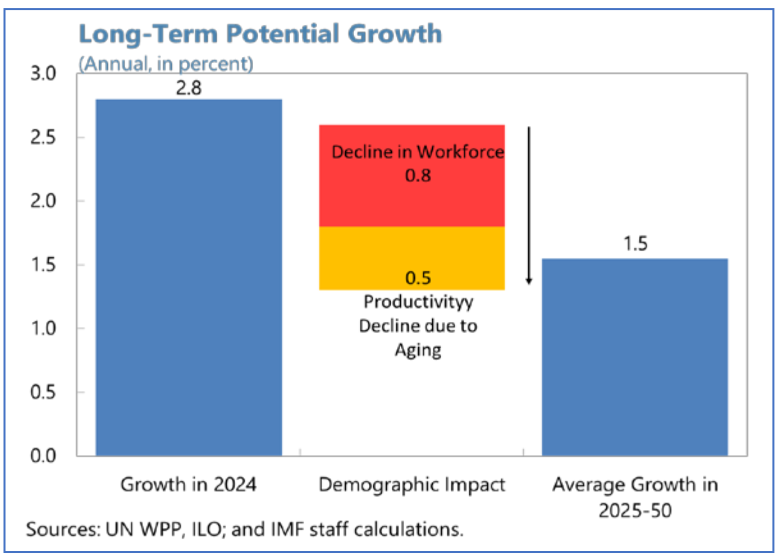
The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook and risks

1. ***Regarding the medium-term outlook, we wonder if the projected growth rates of potential output of at least 3.5 percent until 2023 may be overly optimistic given the presently already materializing decline in the working population. We would welcome additional staff comments on this issue.***

- While the projected potential growth rate may seem over-optimistic, the implied level of potential output shows however that the output gap is closed by 2023.

- Further, assuming a balanced growth path by 2023 and a decline in the working-age population of 0.85 percent (UN population projection) would still yield a potential growth of this magnitude based on the post-crisis trend in TFP growth. Finally, the large impact of the ageing population through a decline in the workforce and productivity are expected to materialize over the very long run from 2025 (Department paper: "Demographic Headwinds in Central and Eastern Europe", Departmental Paper No. 19/12.)



2. ***We understand that the CA model is often more informative and reliable than the REER index model. However, CA and REER gaps should be consistent, reflecting in the case of Estonia, its income convergence, the rise in ULCs, adverse demographics and a loss of competitiveness. Since both CA norm and EBA-lite REER methodologies result in sharp differences, to a negative and positive REER***

gaps respectively, we were wondering if providing ranges for the CA and REER gaps wouldn't be more consistent to accommodate uncertainties in these assessments? Staff's comments are welcome.

- In arriving at the bottom-line assessment, staff draw information from different approaches with consideration of country-specific circumstances and strengths and limitations of each approach while avoiding a mechanical application of the models.

- The differences between the CA model and the REER model are not uncommon and largely reflect different specifications and the fact that the REER tends to be more volatile than the CA model.

- In the case of Estonia staff provides more weight to the CA-model because it generally is better integrated with the macro-policy framework and policy recommendations, reflects a better fit and has lower volatility. We therefore refrain from averaging the different models or having a wide range covering all the results.

- The CA results are also comparable with other non-price and synthetic indicators that are used as in the Eesti Pank in its competitiveness report.

3. ***Related to the previous points, we would like to note that there are no relevant inflationary pressures and real output is still about 10 percentage points (pp) below the counterfactual level implied by the pre-crisis average trend, which contrasts with staff's estimates of the output gap of about 2 pp. In this context, which is shared by several other economies, there is a debate on whether there is a case for running on a high-pressure economy to continue to undo the persistent damage from the global crisis. As shown by the recent US experience, this option would have the additional advantage of benefitting more the most disadvantaged workers through stronger wage growth and better jobs, thus contributing to mitigate inequality. Staff's comments are welcome.***

- We agree that the stronger wage growth would contribute to mitigate inequality and that there is desirable growth in wages that is consistent with income convergence. However, we are concerned about the wage growth persistently outpacing productivity and raising competitiveness challenges. One of the main factors adversely affecting corporate profitability is rising labor costs. The wage growth would be sustainable to the extent that there is improved productivity growth. Therefore, productivity enhancing spending could help both potential growth and provide better job opportunities through the stimulus.

Fiscal policy and debt sustainability

4. ***In the short term, however, the recommendation to end the accommodative fiscal stance might place the authorities in a dilemma of either reducing transfers to households and wage increases in priority occupations or deferring public investment. In this vein, we would welcome comments from staff on the urgency of the recommendation given the extremely low debt level, and on the nature of the savings from recurrent expenditure they suggested to the authorities to observe the fiscal rule.***

- The urgency of the recommendation to end the accommodative fiscal stance is based on the cyclical position of the economy:

- With output above potential and real interest rates low for the foreseeable future and weak productivity, fiscal policy is expected to bear the bulk of the rebalancing of the policy mix. Therefore, unwinding of the accommodating stance would be in line with economic conditions.
- In terms of the nature of recurrent savings, there is scope to reduce wages as the current leeway in the setting of compensation in different line ministries has led to significant increases in public sector wages. Wage growth remained high averaging 8.2 percent in 2019Q3, with public sector wages rising by 10.8 percent compared to only 7.4 percent for the other sectors.

5. ***Given the challenges the country faces, its significant current account surplus and ample fiscal buffers, could staff elaborate on their recommendations to unwind the expansionary fiscal policy in the near term?***

- See response to question 4

6. ***On the tax side, measures including the reduction or non-taxation of reinvested profits in R&D and digital technologies would help bolster investment in new technologies and incentives for innovation. Staff's comments on this issue would be welcome.***

- Staff agrees with the comment.

7. ***We note staff's assessment that there are no major external debt sustainability concerns. Could staff advise on what assessments have been done on the currency and maturity profiles for the large private sector external debt?***

- An assessment of the External debt sustainability reveals that:

- there is no major concerns.
- in addition, while it is true that the largest part of external debt is held by the private sector, 90 percent of the total is held in domestic currency (EUR). Because of lack of data, staff were not able to provide an assessment of the currency and the maturity profiles of the private sector external debt.

8. ***We would like to know more about specific measures to enhance social spending efficiency and volume that might be considered by the authorities.***

- In view of the long-term demographic headwinds, Estonia will have to consider important reforms to enhance social spending:

- The introduction of mean-testing, which requires higher capacity, and targeting (especially on the old age population given the high old age poverty), could be considered. Also, there is room for efficiency gains in healthcare spending which could be achieved by strengthening the primary healthcare system and an effective public health intervention and prevention agenda (SIP—2018 Estonia Article IV "Public expenditure efficiency in Estonia").
- Inequality and relatively low social outcomes in Estonia reflect to some extent low social protection spending. Therefore, pension spending reforms could be considered in order to contain recent increases in old age poverty. Another policy lever could be healthcare spending, in the context of an ageing population while being mindful of the budgetary impact as highlighted in the SIP.

9. ***Could staff elaborate more on the size of infrastructure deficits in Estonia?***

- Estonia has one of the highest ratios of public investment relative to GDP in the EU, thanks partly its use of EU funds. Estonia ranks high on the EU transport score card for high quality across ports infrastructure. Airport infrastructure has also improved recently:

- However, as a peripheral country with low population density, a well-functioning and interconnected transport system is key for Estonia's economic activities and exports. Investment needs in the transport sector are still considerable, estimated at €3.5 billion by the Estonian authorities the bulk of which €2.4 billion needed for core Trans-European Transport network.

- To address the gaps, an agreement between the Governments of the Republics of Estonia, Latvia and Lithuania on the Development of the Rail Baltic/Rail Baltica Railway Connection was adopted on 19 June 2017. Rail Baltica is essential for addressing challenges of congestion, sustainability and connectivity with the rest of the internal market. Estonia is also participating in the Three Seas Initiative which aims to improve transport, energy and digital interconnectedness.

Pension reforms

10. ***We invite staff to comment on the feasible options to mitigate the potential implications should the government continues with the process to make pillar II voluntary.***

- The current proposed changes to the pension system could have potential implications for the savings of individuals. They could also affect the economy and the financial system. To mitigate these potential effects:

- Define clearly the results expected from the proposed new system and consult widely on the desirable size of future pensions, retirement age, and how to raise taxes to cover future costs. The comprehensive picture should make clear the relative size of the pension that the state will provide in the future, and the cost of the pension system.

- If people start to spend their pension savings immediately, it will make growth in the economy more volatile. To balance this, it would be wise for the government to avoid spending additional tax revenues, and to lengthen the minimum period for withdrawing pension savings;

- Consider ways of encouraging people to save for retirement through the funded pension;

- Protect those shareholders who have put their money into second pillar pension funds that have invested most in the Estonian economy and have least liquid assets.

- Ensure that an adequate IT infrastructure that supports payments and assessment of investment options is implemented and effective ahead of introducing the reforms.

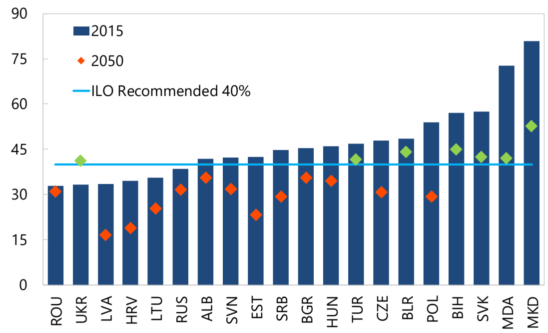
11. ***Could staff elaborate on how Estonia's pension system compares with its EU peers and more broadly to similar countries with aging population?***

Comparing the pension systems of Estonia to those of EU peers is challenging, due to wider-ranging differences in schemes, taxation, and retirement ages and other factors. However, one could note that:

- Estonia's pension system has relatively lower replacement rates compared to those of its peers and total pension and health care fiscal costs are projected to increase on average, between 2015 and 2050 by 4.8 percentage points as indicated in Annex IV.

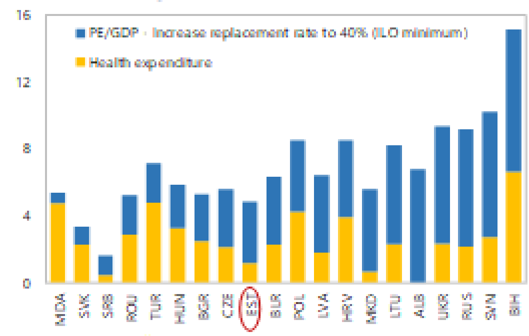
Estonia Pension System replacement rates and costs

Pension Replacement Rate, 2015-2050
(In percent)



Source: IMF staff calculations.

Projected Age-Related Spending Increases
(Percent of GDP, change from 2015 to 2050)



Source: IMF staff calculations.

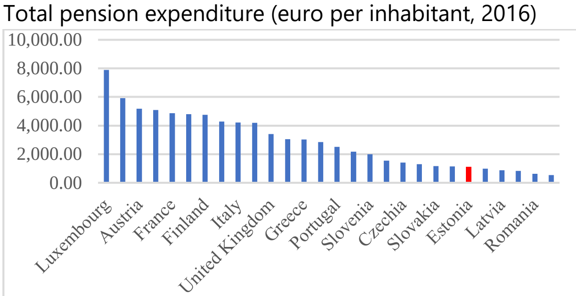
- Based on the ratio of total pension payments in a year to number of pensioners claiming them, as calculated by the OECD, Luxembourg ranks high at €2,219 per month and Bulgaria lowest at €156 per month. Estonia lies at the lower end of the scale at €450 per month placing it 20 out of 28 countries in the EU and is below Finland at €1,529 per month but is ahead of Latvia at €296 per month. As shown in the figures below, expenditure on pensions is lower compared to that of peers and the administrative costs of pension funds are higher than in EU peers.

- Pillar II system voluntary or mandatory: While there is no standardized approach in setting up pillar II system in the EU, Estonia is among those countries that maintain a mandatory system.

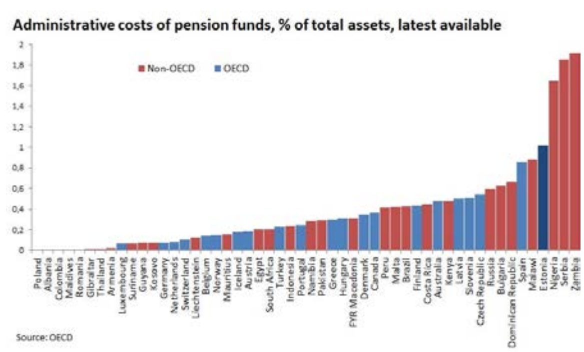
Estonia's Pension System

Expenditure on pensions is lower compared to Euro peers

Total pension expenditure (euro per inhabitant, 2016)



Estonia's pension has one of the highest costs



Financial Sector

12. ***We would appreciate staff's comments on the pass-through effects of the international trade risks and the real estate sector to the Estonia's banking system.***

Pass-through effect could be assessed through trade linkages and funding through the banking system:

- Estonia is a small open economy with a concentration of exports in a few countries. Exports to Finland, Sweden, Latvia, Germany and Lithuania represent roughly 65 percent of total exports. Given the strong trade linkages with Nordic countries a weakening of economic growth in Germany and these countries may affect the Estonian banking system. Indeed, there might be a second-round effect through the impact of a weakening in demand in the Nordic countries on the Estonian economy. We also estimate that trade tensions and weaker than expected growth in trade partners countries may cut growth by 0.3 ppt and 0.5 ppt respectively.

Finland	20.11
Sweden	17.33
Latvia	11.70
Germany	8.13
Lithuania	7.22

- The Estonian banking system is mostly Nordic-owned and has strong interlinkages with the Swedish banking groups, rendering it vulnerable to risks facing the parent groups. Although most bank funding comes from domestic deposits, the supply of credit is also affected by lending standards and terms of the parent groups and how much they are willing to supply to the Estonian subsidiaries. Also, financial markets generally consider risks faced by the parent banks including for AML/CFT as also affecting the domestic banks. These interlinkages could expose the sector.

13. ***We would appreciate staff's comments on the extent of improvements in banks' vulnerability to the real estate sector in recent years?***

- The global financial crisis revealed how the Estonian economy was exposed to an adverse external environment and more especially developments in the international financial markets, including to Nordic-banks. Based on these vulnerabilities, the authorities have undertaken measures to enhance the resilience of the banking system and restore banks' profitability:

- With a view to reduce the risks from excessively fast growth in housing loans, the central bank introduced housing loan requirements including the loan to value limit, debt service to income ratio, and the maximum loan maturity in 2015. In addition, the countercyclical capital buffer was introduced in 2016 to reduce the risks from excessively fast loan growth.

- In order to mitigate risks arising from a possible decline in the ability of companies to service loans because of a fall in exports, the central bank introduced a systemic risk requirement that was set at 1 percent in 2016. An additional buffer requirement for systemically important credit institutions was simultaneously introduced to support their resilience further.

- More recently, the bank introduced an average risk weighted floor for banks that use internal ratings-based model in order to prevent excessive risk taking for mortgage loans. Household debt to GDP ratios have since declined to around 40 percent from above 50 percent in the post global financial crisis and from above 100 percent to below 80 percent for companies.

14. ***We would like to ask staff whether the integration of Basel output floors into the EU rules on capital adequacy would change the so far very good capitalization of Estonian banks.***

- Staff understands that the integration of Basel output floors for banks when using internal ratings based (IRB) approach to calculate risk exposures will come into force in 2022:

- Under the revised Basel principles, the level of total risk exposures at IRB banks should be at least 72.5 percent of the total risk exposure amount calculated using the standardized methods. A gradual transitional period to this rate is foreseen, as the regulatory output floor will be 50 percent in 2022 and will rise to 72.5 percent by 2027. This means that in future the minimum level required for risk weights will be notably higher than the current models. The introduction of the minimum required level for setting risk weights for IRB banks makes the transition smoother.

- The Eesti Pank estimates that subjecting IRB Banks to an output floor of 72.5 percent would put the average risk weight for those banks at about 19.8 percent *(Financial Stability Review for 2019 edition 1)*. So, the integration of the new floors is not envisaged to significantly change the good capitalization of the IRB banks.

15. ***We note a significant decline of RoE in 2019Q2, and a concurrent decline in RoE in this period, the reason of which is not explained in the report. Staff's comments would be welcomed.***

- The decline in earnings and profitability for 2019H1 was attributed to losses recorded for Danske bank from the sale of its loan portfolio of private clients to LHV bank and relatively end-year large dividends in 2018Q4

16. ***Could staff also elaborate the progress made in strengthening cross-border supervision and the results of the crisis simulation exercise for the eight Nordic-Baltic countries?***

- Cross-border supervision has been an important dimension in the financial policies of the Estonian authorities. In that line, a crisis simulation for the eight Nordic-Baltic countries and involving the European Single Resolution Board and the European Commission was run on January 22 and 23, 2019:

- The simulation involved 31 organizations, including the central banks, the supervisory authorities, the resolution authorities and relevant Ministries while the ECB (SSM) and the IMF were observers. It involved testing different aspects of national and regional crisis response. During the simulation, participants were confronted with a highly stressed financial sector environment.
- In terms of liquidity support, further clarification of the responsibilities for liquidity provision in the subsidiaries, as well as proactive communications and coordination between the home and host would be desirable.
- In relation to supervisory actions, supervisory authorities were prompt in recognizing the severity of problems in individual banks and mounted a firm response but there was a need for better coordination among agencies on the factors triggering the fail or likely to fail (FOLTF) and resolution decisions.
- With respect to bank resolution, the simulation identified room for improving the crisis management framework especially under a challenging and stressed environment. The simulation also highlighted the need for enhanced coordination among agencies especially when handling the failure and resolution of financial institutions posing high systemic risk. While the agencies clearly need to act under their legal mandates, decisions should be coordinated and take a comprehensive perspective with all the engaged authorities pro-actively involved.

17. ***Apart from the need to improve coordination and communication between agencies of the home and host countries, what other key lessons were acquired from the simulation exercise?***

- See response to question 16.

18. ***Can staff provide an update on the status of the legislation that would increase the maximum fine for violations?***

- The draft legislation that would increase the maximum fine for AML/CFT violations was approved by the Government and submitted to the Parliament in May 2019. In addition to this legislative initiative to increase the maximum fines under the criminal framework, the authorities are discussing streamlining and simplifying the process of imposing fines on financial institutions by reintroducing an administrative sanctions regime for AML/CFT violations.

19. ***Finally, staff indicated in ¶36 that "potential impact of AML/CFT risks on the macroeconomy is yet to be quantified". Could staff clarify why such an exercise has not been conducted?***

- The impact of AML/CFT risks on the macroeconomy is on-going and data to inform the assessments of the impact is being gathered from different stakeholders. Once the data collection process is completed, a proper assessment will be done.

20. ***We look forward to the conclusions of the forthcoming MONEYVAL assessment. Could staff indicate when this assessment is expected to be finalized?***

- The exact dates for the on-site visit by MONEYVAL assessors are not set yet. The authorities expect it to take place in 2021, with the MONEYVAL plenary discussion and publication in 2022.

21. ***While we welcome the planned assessment of the AML/CFT regime by MONEYVAL in 2022, in light of AML/CFT vulnerabilities, we wonder whether there is flexibility to bring the assessment forward and would appreciate staff's comments whether focusing solely on Estonia is sufficient.***

- The schedule of MONEYVAL assessments includes assessment of all its member countries and is approved by MONEYVAL. All the other Nordic-Baltic countries have already been assessed under the most recent version of the FATF standard and are subject to follow-up processes. The MONEYVAL assessment of Estonia will include an analysis of the cross-border ML/TF risks.

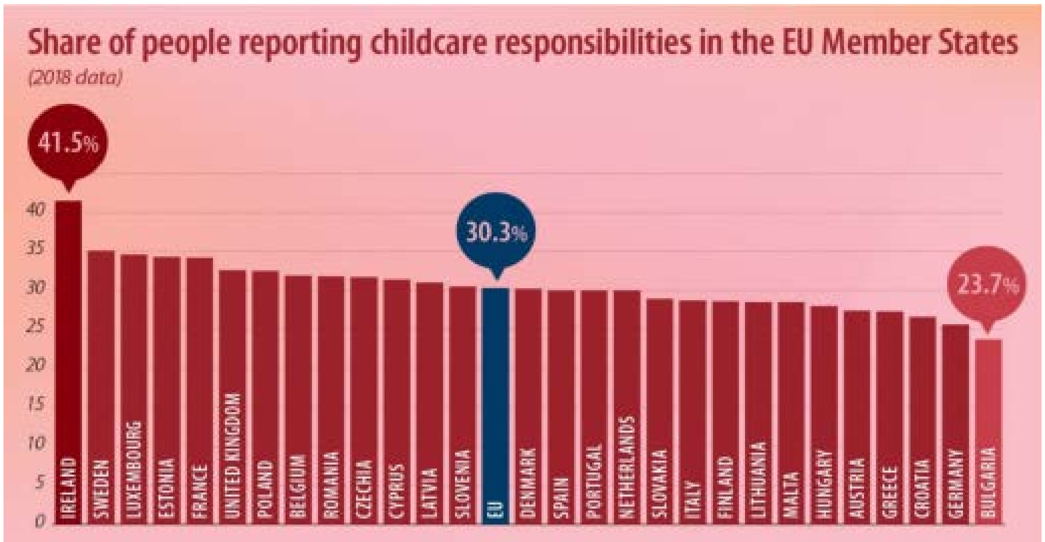
Structural reforms

22. ***We take note of staff's recommendation to extend the availability of childcare to incentivize full-time employment but wonder whether this is enough given the magnitude of the problem.***

- The negative impact of parenthood on the employment of women has been recognized as a significant challenge in Estonia (See the European Commission report "Barcelona Objectives", 2018)

- While the gender pay gap (GPG) is high, it has been on a declining trend as shown in the SIP (Dimensions of Inequality in Estonia). Estonia has one of the highest shares of people reporting childcare responsibilities (See chart: source Eurostat)

- In addition to increase availability of child care, two main broad policy areas were highlighted in the SIP: (i) a transparent reporting policy of gender pay gap, as already applied by the authorities in some public entities, extended to other sectors would be a significant step; and (ii) less occupational gender biases and career interruptions by women may help reduce the GPG without raising female unemployment.



23. ***We would like staff to elaborate on the main barriers for higher productivity growth in Estonia.***

- There are two main barriers to productivity growth in Estonia: structural factors and policy related factors.

- Structural factors such as constrained investment in intangibles assets in distressed firms during the crisis, slow capital-embodied technological change and the policy uncertainty environment slowdown productivity in Estonia, like in many other advanced countries.
- Other structural factors include an ageing workforce, slower accumulation of human capital and slowing global integration. Further, the lengthy insolvency regime that can trap financial resources in less productive firms, the dominance of low and medium low-technology firms in the economy, the shortage of labor in the high skill segment of the market. Export orientation has been shown to increase productivity but only a few Estonian firms export (12 percent in 2014, Benkovkis et al, 2017, Export and productivity on GVCs, OECD paper). Consistently, a SIP "Productivity developments in Estonia: Evidence from firm level data" highlights a lack of dynamism as young firms under-perform.

- Regarding policy related factors, the fiscal tightening leaves less room for productivity enhancing spending, hence staff policy recommendation.

24. ***Given these circumstances and despite closer oversight by the Research and Development Council (RDC) in the Prime Minister's Office, we invite staff to elaborate their assessment of the effectiveness of the RDC and the potential corrective measures.***

- In line with staff recommendations, the authorities established recently (late 2017) both the Research Development Council (RDC) as advisory group and the Economic Development Committee (EDC) under the prime minister's office. These new institutions were tasked at overseeing and coordinating productivity-enhancing policies.

- It seems therefore too early to assess the effectiveness of the RDC. The establishment of the RDC provided however a potentially strong mechanism for coordinating national R&D policy and reach spending goals in that regard. As of now, the RDC has safeguarded the political commitment to the importance of an R&D policy by ensuring a consensus among all the political parties. This is important in order to ensure continuity across successive governments.

- Going forward, establishing thematic priorities, supporting greater efforts by the private sector to increase their allocation; and implementing policies that support increasing R&D capacity would be desirable (according to the Peer Review of the Estonian Research and Innovation System Report). Staff will follow up on the need to assess the effectiveness of these units in the next Article IV Consultations.

25. ***We note that Estonia is one of the most digitally advanced nations in the world. Could staff elaborate what role the high digitalization can play in enhancing economic productivity and supporting the labor supply?***

- Digitalization has provided many opportunities to enhance the efficiency of Estonian firms in many regards:

- Through digital technology, Estonia has achieved an efficient revenue collection as highlighted in the chapter 2 of April 2018 Fiscal Monitor.
- However, productivity remains moderate suggesting that other factors may be important. Other factors such as constrained investment in intangibles assets in distressed firms during the crisis, slow capital-embodied technological change and the policy uncertainty environment could be also in play in limiting the growth of productivity (Staff Discussion Note "Gone with the Headwinds: Global Productivity"). A recent OECD report "Digitalization and productivity: A story of

complementarities" suggests that the aggregate productivity gains from digitalization have not been sufficiently large to offset these headwinds.

- As to the labor supply impact, it is not clear-cut. Indeed, digitalization can displace workers but also create jobs and the net effect is not obvious, especially in a country with demographic challenges.

26. ***Staff's comments on whether the authorities are considering relaxing the immigration quotas for non-EU and non-EEA countries are welcome.***

- While we assess the immigration quota to be low, the authorities' view is that the 0.1 percent relative to the size of the population is nonnegligible. Applying this maximum quota for 2020, the Ministry of the interior is proposing a quota of 1,314 (this is almost the same as in 2019 where the quota was 1,315). In addition, they highlighted the fact that there is an exemption for some categories including in ICT and top specialists. There is no current plan to relax the immigration quota as in the coalition agreement it is clearly stated as follows: "We will follow a rigorous immigration policy for the Estonian economy and society. We will intensify our control over illegal immigration and review the exceptions to the immigration quota that are being abused".

27. ***Does staff see a role for some type of industrial policy in the Estonian case?***

- Staff see scope for an industrial policy for Estonia. The authorities prepared a Green Paper on Industrial policy working closely with the Chamber of Commerce and Industry which sets out challenges in the sector and offer potential solutions.

- The objective of the green paper is to increase the industry's competitiveness by raising the value per employee from the current 54 percent to at least 100 percent of the EU average by 2030.

- The focus of the green paper is on: establishing a support program for the digitalization and automation of the industry; increasing state funding for research and development activities; facilitating more long-term finances including loans; alleviating labor needs through more use of foreign labor and flexibility of the education system to support changing labor needs.

28. ***In 2016 Article IV assessment, staff highlighted the limited attractiveness of Estonia's life-long learning strategy, we would welcome staff comments on the recent developments in this regard.***

- The general goal of drafting the Lifelong Learning Strategy is to provide all people in Estonia with learning opportunities that are tailored to their needs and capabilities throughout their whole lifespan:
- The target level for 2020 regarding the participation rate in lifelong learning among adults (percent of 25-64- years old who stated that they had received education or training during the four weeks preceding the survey) is 20 percent from a 12.9 percent starting level in 2012. While in the 2016 Staff Report, it was stated that the strategy has yet to attract more applicants, in 2018, the participation rate reached 17 percent (Source: European Association for the Education of Adults).