ESTONIA

Highlights

- **Gross domestic product (GDP) growth has decelerated somewhat.** Higher investments, mainly by non-financial companies, and increased government spending underpinned GDP growth in the first half of 2019. At the same time, household consumption has moderated despite rising wages.
- **Anti-money laundering supervision has been strengthened.** The Nordic and Baltic states' financial supervisors have agreed on measures to enhance the cooperation among the countries' authorities, with the aim of fighting money laundering and the financing of terrorism.
- **The banking sector has expanded and become more concentrated.** The acquisition of Luminor Bank by Blackstone was one of the largest mergers and acquisitions (M&A) transactions in the history of the Baltic states.

Key priorities for 2020

- **The development of new and innovative technologies in the country's financial markets should advance.** Regulatory sandboxes, which are a live testing environment for technology and FinTech companies against regulation, may help in designing an environment that supports innovative start-ups.
- **Reforming the second pillar pension system should take into account the system's sustainability.** The established funded pension working group will need to work out appropriate solutions to the problem of pension sustainability in the context of a rapidly ageing population and adverse demographics.
- **Strengthening anti-money laundering (AML) supervision should remain a priority.** While AML risks in the banking sector have declined markedly and the risk-based supervision of financial institutions has been implemented, efforts at further deepening regional cooperation should be continued.

Main macroeconomic indicators %

	2015	2016	2017	2018	2019 proj.
GDP growth	1.8	2.6	5.7	4.8	3.2
Inflation (average)	0.1	0.8	3.7	3.4	2.5
Government balance/GDP	0.1	-0.5	-0.8	-0.6	-0.2
Current account balance/GDP	1.8	1.7	2.7	2.0	1.5
Net FDI/GDP [neg. sign = inflows]	0.6	-2.4	-3.9	-4.7	-4.0
External debt/GDP	92.2	88.5	83.1	76.4	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	68.6	70.2	64.5	62.1	n.a.

CONTINUES

Macroeconomic performance

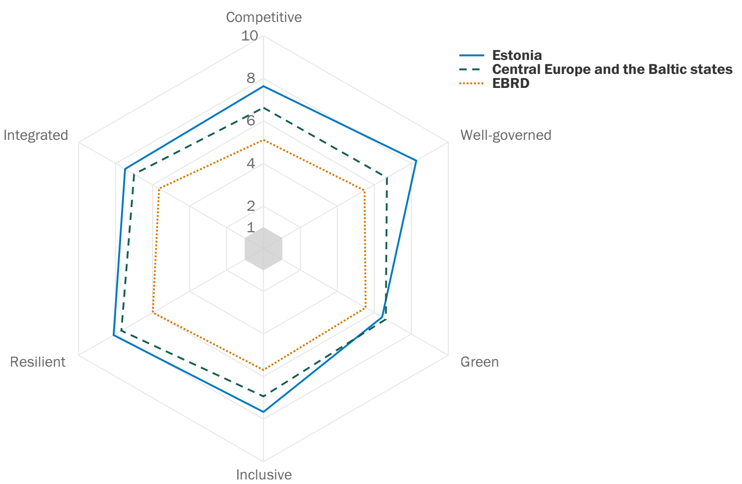
Domestic demand continues to fuel economic growth. GDP growth decelerated to 4.9 per cent in 2018, largely driven by strong consumption-driven imports, which significantly outperformed exports. In the first half of 2019, economic expansion decelerated to 4.2 per cent, mainly due to moderating household consumption. Nominal wage growth reached almost 8.0 per cent on average in the first half of 2019, causing unit labour costs to grow faster than labour productivity. This reflects a shrinking labour market and raises concerns about Estonia's prospective competitiveness.

Investment has recovered. Following a slowdown to 1.7 per cent in 2018, gross fixed capital formation rose by 21.4 per cent in the first six months of 2019. Non-financial enterprises registered higher investment expenditures into transportation equipment and machinery. Household expenditures into dwellings increased markedly as well. Credit to non-financial companies turned positive in the third quarter of 2018, especially long-term credit (over five years), which has grown by more than 10.0 per cent since then.

Fiscal expenditures will continue to grow. In 2018, the general government balance fell to a deficit of 0.6 per cent of GDP, mainly due to higher-than-expected social spending and investment. According to the ruling coalition's action programme for 2019-23, fiscal expenditures are expected to grow, especially on family policies, pension hikes, healthcare and defence. Public debt continues to fall, reaching 8.4 per cent of GDP in 2018. According to European Commission estimates, it will likely remain low, at around 8.5 per cent of GDP in the coming years.

Short-term GDP growth will remain buoyant. The tightening labour market will result in further wage increases, keeping household consumption elevated. At the same time, mounting labour shortages and competitive pressures will likely force companies to invest in efficiencies unless the outlook worsens severely. Negative risks to the outlook come from intensification of trade tensions and weaker export demand in advanced economies, especially in the Nordic region. As a result, GDP growth is anticipated to slow to 3.2 per cent and 2.6 per cent in 2019 and 2020, respectively.

Assessment of transition qualities (1-10)



CONTINUES

Major structural reform developments

Cross-border cooperation on AML supervision has strengthened. In May 2019, the heads of the Nordic and Baltic states' financial supervisors agreed on measures to enhance their cooperation with the aim of fighting money laundering and combating the financing of terrorism (CFT). In July 2019, the Estonian government decided to amend the penal code and relating laws to adopt the European Union (EU) directives on protection of EU financial interests, which increases the maximum length of imprisonment for money laundering. Further work on strengthening the AML/CFT framework will continue. Recently, the total share of non-resident deposits from high-risk clients without any links to the Estonian economy dropped substantially. It went down from 18.6 per cent at the end of 2014 to 7.2 per cent at the end of 2018, while the share of offshore deposits declined from 3.9 per cent to just 0.5 per cent over the same period.

The banking sector has expanded and became more concentrated. In September 2018, the Nordic banks Nordea and DNB announced that they would sell a 60 per cent stake in Luminor Bank, which operates in the three Baltic states, to Blackstone, the United States of America-based private equity giant. This acquisition, with a value of €1 billion, is one of the largest M&A transactions in the history of the Baltic states. As a result, the size of the banking sector in Estonia will increase from 102 per cent to 145 per cent of GDP and the sector will become more concentrated, as the three largest banks hold a market share of 85 per cent. In January 2019, the European Commission cleared the deal and stated that it raises no competition concerns, given its limited impact on the market structure. The deal is still awaiting the approval of the European Central Bank before it materialises in late 2019.

A covered bond law has entered into force. Estonia is the first of the Baltic states to adopt covered bond legislation, which came into force in March 2019. Estonia, Latvia and Lithuania started work on developing covered bond and securitisation frameworks in late 2017, with the aim of creating a pan-Baltic covered bond market. The new law enables banks to diversify funding sources and limit their reliance on parent funding. Estonia's Luminor Bank is expected to make the first covered bond issuance, preceded by various structural and ownership changes in 2019 that will help to raise new secured funding in the pan-Baltic market.

The pension system is becoming more flexible. In December 2018, the parliament adopted a bill that ties the retirement age to average life expectancy, starting from 2027. In addition, the pension payment will depend on both the final salary and the person's length of service. The flexible pension will allow employment on a part-time basis. In addition, the government plans to reform the second pillar pension fund. As a result, FinanceEstonia, a public-private financial sector cluster organisation, established a funded pension working group in June 2019 to formulate solutions for the Estonian social security system.

Additional measures for preventing corruption were introduced. In January 2019, the parliament adopted an amendment to the law to reduce the risk of corruption and conflicts of interest at the local government level. Compared with the previous year, Estonia advanced three places to joint 18th (out of 180 countries) in Transparency International's 2018 Corruption Perception Index.

Estonia is advancing in climate change adaptation. In December 2018, Estonia joined a political declaration that focuses on comprehensive and sustainable management of forests, accepted at the UN Climate Change Conference in Katowice, Poland. The declaration emphasises the importance of forests as carbon sinks and stresses that their ability to adapt to climate change needs to be improved. Estonia is rich in woodland, and the share of strictly protected forests is at the forefront of EU efforts to combat the negative effects of climate change.