ESTONIA

Highlights

- **GDP growth peaked in 2017.** Last year, economic growth reached nearly 5 per cent, largely boosted by a double-digit hike in investment and strong household consumption.
- **A pension reform bill has been approved.** It modifies the formula for pension calculations and ties the retirement age to the average life expectancy from 2027 onwards. In addition, a three-pillar system will be introduced and special pensions for certain professions will be abolished from 2020.
- **Port Tallinn was privatised through the local stock exchange.** In addition to corporate governance improvements, the transaction will support the development of the local capital market, as it provides opportunities to investors, including institutional investors such as local pension funds.

Key priorities for 2019

- **The first covered bonds should be issued in 2019.** The expected adoption of the Covered Bonds Act in 2019 creates an opportunity for banks to issue covered bonds and for different investors to invest in them, thereby broadening Estonia's capital market.
- **Estonia's research and innovation potential needs to be better utilised.** The country has been a leader in the region in terms of its innovation achievements, but bottlenecks still need to be addressed, such as the weak links between business and academia and the low level of private investment in research and development.
- **Reducing the gender pay gap would encourage an increased female labour force participation.** Estonia has the highest gender pay gap in the European Union (EU) with an average wage difference between men and women of 25.3 per cent, much higher than the EU average of 16.2 per cent. Improving wage transparency, including through the adoption of the Gender Equality Act and reviewing the parental leave system, both planned for 2018-20, are steps in the right direction.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
DP growth	2.9	1.9	3.5	4.9	3.6
Inflation (average)	0.5	0.1	0.8	3.7	3.3
Government balance/GDP	0.7	0.1	-0.3	-0.3	-0.4
Current account balance/GDP	0.8	1.8	2.0	3.2	1.8
Net FDI/GDP [neg. sign = inflows]	2.4	0.6	-2.3	-3.7	-6.0
External debt/GDP	94.9	92.8	88.4	82.6	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	67.8	69.1	70.2	65.0	n.a.

CONTINUES

Macroeconomic performance

GDP growth has been strongly driven by domestic demand. Following four years of negative or moderate growth, investment saw a two-digit growth rate in 2017. Amid still-strong household consumption, GDP growth reached 4.9 per cent last year. However, the rate of growth slowed down to 3.5 per cent year-on-year in the first half of 2018, largely induced by a deceleration in investment. The favourable external environment has benefited solid exports, but its positive effect on GDP was effectively offset by the strong growth in domestic demand-driven imports.

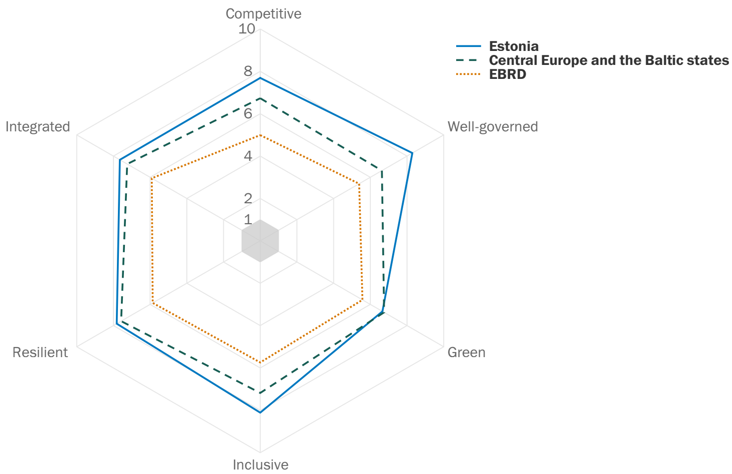
The investment share in GDP remains the highest in the EU. In 2017, the gross fixed capital formation represented 23.7 per cent of GDP, clearly above the EU average (20.1 per cent) and Estonia's regional peers. In 2017, the share of public investment in GDP was the highest in the EU, at 5.6 per cent, which is close to its 10-year average of 5.5 per cent. Nevertheless, these high figures have been strongly dependent on EU funds, which have constituted about half of total public investment expenditures. Therefore, the risk related to an abrupt fall in public investment exists if the new EU budget for Estonia is reduced substantially.

Labour shortages have increased. According to EU surveys, the share of companies complaining about the lack of labour increased to almost 27 per cent in the third quarter of 2018, which represents a 10 percentage increase compared with the beginning of 2017. Overall, the labour market in Estonia has performed well, positively stimulated by the government's labour market policies, such as the Work Ability programme launched in 2017 which aims to bring disabled people into the labour market. But the falling working-age population imposes challenges. The employment rate reached almost 80 per cent in the second quarter of 2018, while the unemployment rate has dropped below 5 per cent.

Public finances remain healthy. The budget deficit in 2017 remained at 0.3 per cent of GDP, slightly lower than expected as the robust economic growth underpinned strong revenue collection. The 2018-2022 Stability Programme, adopted by the government in April 2018, envisages a headline fiscal surplus of 0.2 per cent of GDP this year, which is expected to further widen by 2020. The government has been targeting a move from a broadly balanced fiscal policy to a counter-cyclical fiscal contraction in response to the economic growth above its potential and the high risk of overheating. General government debt dropped to 9.0 per cent of GDP in 2017 and is expected to remain on a downward trend.

GDP growth is forecast to moderate. Following a strong recovery in 2017, economic growth is expected to decelerate to 3.6 per cent in 2018 and further to 3.0 per cent in 2019. The key drivers of the slow-down are the expected weaker investment and exports. In contrast, rising wages will likely further underpin strong household consumption, which will be only fractionally offset by the expected rise in inflation.

Assessment of transition qualities (1-10)



CONTINUES

Major structural reform developments

Port Tallinn was privatised through the local stock exchange. In June 2018, the government sold a 33 per cent stake in AS Tallinna Sadam (Port of Tallinn) through an initial public offering on the Nasdaq Tallinn Stock Exchange. This transaction was the first state-owned company listing in Estonia for almost 20 years. It is expected both to improve corporate governance, through strengthened transparency and efficiency of the company, and to support the development of the local capital market, as it provides opportunities to investors, including institutional investors such as local pension funds.

Electricity market synchronisation has progressed. In June 2018, the three Baltic countries, Poland and the European Commission signed an agreement for the synchronisation of the Baltic power grid with the continental EU network by 2025. The synchronisation of the power grid, which is expected to go through Poland, is anticipated to offer a major contribution to the solidarity and energy security of the EU. Also, it is one of the key goals of the EU's Energy Union project, which was launched in February 2015. Currently, the Baltic states' electricity grid is still operated in a synchronous mode with the Russian and Belarusian systems.

The pension system is being made more flexible. In April 2018 the government approved a pension reform bill. Among other measures, the bill modifies the formula for pension calculations and ties the retirement age to average life expectancy from 2027 onwards. The pension system will consist of three pillars: a first pillar building more on social solidarity, which will depend on the number of contributory years; a second pillar depending on the size of wages; and a third pillar based on people's voluntary contributions. In addition, special pensions for some professions, such as the military, prosecutors and police, will be abolished from 2020. The reform partly addresses the risks to the future sustainability of the pension system. Nevertheless, given the currently low pensions, ensuring adequate pensions in the future remains a challenge, especially for low earners, the disabled and people with short professional careers.

Plans for an undersea railway tunnel between Tallinn and Helsinki have advanced. This project, if carried out, would contribute to the effective creation of a metropolitan "twin-city" of Helsinki and Tallinn. A taskforce, comprising the relevant ministries of Estonia and Finland, concluded in May 2018 that private funding would be required to speed up the progress of the project and to strengthen its financial viability. According to the first feasibility study, published in February 2018, a 103 km tunnel between the two capital cities would cost between €13 billion and €20 billion and its construction could start in 2025 and take 15 years. Its financing would be organised through a public-private partnership and EU funding of up to 40 per cent. The tunnel would be part of the Trans-European Transport Network (TEN-T) and be connected with the Rail Baltica line.

Covered bonds will broaden the Estonian capital market. The Ministry of Finance sent a draft of the Covered Bonds Act for public consultation in August 2018. This creates an opportunity for banks to issue covered bonds and for different investors to invest in them, thereby broadening the Estonian capital market. In November 2017, the ministers of finance of the Baltic states agreed to establish a pan-Baltic covered bond market. The purpose of the cooperation agreement promoting the Baltic capital markets is to make the local capital market more effective. Additional provisions to the draft law necessary for the functioning of the pan-Baltic covered bond market will be considered later. The law should enter into force in 2019.

Local administrative reform was implemented. Starting from January 2018, the number of municipalities has been reduced from 213 to 79. The key aim of the reform is to increase the role of local governments and better divide the competencies of the state institutions. In addition, larger municipalities should have improved capacity to offer better quality services and invest in necessary infrastructure. In addition, the county governments were abolished and their tasks have been distributed among local councils and the different existing authorities.