ESTONIA

Highlights

- **GDP is falling sharply.** Containment and lockdown measures have strongly affected private consumption, exports and investments, but a fiscal stimulus of around 9 per cent of GDP is mitigating the impact by supporting employment, firm liquidity and local development.
- **The government has prioritised an insolvency framework reform.** The authorities have made progress on facilitating insolvency-related proceedings by establishing a new monitoring unit and partially increasing the efficiency of the process.
- **The pension system has been altered, with uncertain effects on capital markets development.** The adopted change to voluntary contributions to the second pillar brings short-term fiscal benefits but limits liquidity in the capital markets and makes the stability of the system crucially dependent on statutory retirement and minimum pension decisions.

Key priorities for 2021

- **EU recovery funds should be used to stimulate the recovery by boosting innovation and greening the economy.** Around €6.8 billion has been earmarked for Estonia in the next European Union (EU) budget, including the EU recovery instrument. The authorities should use these funds in investments that would improve the long-term growth potential of the economy, including the reduction of the carbon footprint of its energy sector.
- **Anti-money laundering and countering the financing of terrorism implementation needs to be finalised.** Despite some noteworthy progress and political commitment to address the shortcomings flagged by the European Commission (EC), gaps still exist and should be addressed, including cooperation at the level of the three Baltic states.
- **Addressing inequality gaps, especially following the coronavirus crisis, will become more important.** Income inequality and relative poverty remain elevated, and the risk of an increasing gap is high as containment measures significantly affected those in lower-paid jobs.

Main macroeconomic indicators %

	2016	2017	2018	2019	2020 proj.
GDP growth	3.2	5.5	4.4	5.0	-4.0
Inflation (average)	0.8	3.7	3.4	2.3	0.2
Government balance/GDP	-0.5	-0.8	-0.6	-0.3	-6.8
Current account balance/GDP	1.2	2.3	0.9	2.0	4.0
Net FDI/GDP [neg. sign = inflows]	-2.4	-3.9	-4.7	-3.5	-2.0
External debt/GDP	88.0	83.4	77.4	73.8	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	69.4	64.3	62.3	59.4	n.a.

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Covid-19: macroeconomic implications

Estonia entered the Covid-19 crisis after a year of robust growth. GDP grew by 4.3 per cent in 2019, with investments and net exports driving most of this growth. However, in the first half of 2020, the economy was significantly affected by the pandemic, with GDP declining by 3.9 per cent year-on-year, and by 6.9 per cent in the second quarter year-on-year. Although consumption expenditure edged up by 0.2 per cent, investment fell by 13.1 per cent and exports dropped by 2.6 per cent in the first half of 2020. Nevertheless, good economic fundamentals, such as the solid fiscal stance, current account surplus, and a financial sector in good shape, have enabled a strong policy response to the crisis so far, which together with an effective health response allowed the economy to swiftly begin recovering. Retail turnover declined by 15.8 per cent year-on-year in April 2020, the lowest point, but started gradually recovering as of May. On the other hand, industrial production declined by 16.9 per cent in April, but was slower to recover because of similar difficulties in trading partners.

Unemployment has risen while prices declined. The unemployment rate reached 8.0 per cent in July, triggering a slowdown of wage growth in the first half of the year to 2.9 per cent year-on-year. Prices have been declining during the lockdown and in the months following it, given the shock to demand. The steepest fall was recorded in May at -1.7 per cent year-on-year, driven mainly by price drops in transport, housing, and catering services.

The fiscal deficit has widened considerably. In the first half of 2020, the deficit had already reached 3.3 per cent of GDP (versus 0.3 per cent in 2019) and it is expected by the International Monetary Fund (IMF) to reach -6.8 per cent for the year as a whole. Public debt is forecast by the IMF to be 18.7 per cent of GDP by the end of 2020, up from 8.4 per cent at the end of 2019 but still exceptionally modest by EU standards. To finance the deficit, the government raised €1.5 billion through a 10-year bond in June 2020, and borrowed €750 million from the Nordic Investment Bank as a 15-year loan and €200 million from the Council of Europe Development Bank.

GDP growth is expected to recover in 2021 but uncertainty remains. As the bottom of the crisis was likely reached in April 2020, the economy has started to go through a long recovery phase since the relaxation of containment measures. As such, we forecast a 4.0 per cent fall in GDP in 2020, followed by a strong recovery of 4.0 per cent in 2021. This is of course contingent on, among other things, whether other Covid-19 outbreaks will happen this year or in 2021 in Estonia and elsewhere.

Policy response to Covid-19

A significant stimulus package was adopted. In addressing the socio-economic impact of the health crisis, the parliament approved a supplementary budget on 15 April 2020. Under this budget, the government earmarked a support package of almost 9 per cent of GDP. Key measures include support to the Unemployment Insurance Fund to finance the job retention scheme, covering 70 per cent or up to €1,000 per month for affected companies, and reduced to 50 per cent or €800 in June (at a total cost of €250 million). The health system will also receive about €200 million. In terms of liquidity support, the government, both directly and through the state-owned KredEx, will offer guarantees for bank loans to allow for rescheduling of payments (€1 billion), subsidised working capital loans (€500 million), and investment loans (€50 million). Budgetary support to local authorities was also earmarked (€130 million), while rural companies will be able to receive business loans, guarantees and land capital through the rural development fund (€200 million).

The central bank has released additional liquidity in the banking sector. As part of the eurozone, Estonia has benefited from the quantitative easing mechanism adopted by the ECB, the €1,350 billion pandemic emergency purchase programme (PEPP). Additionally, the Eesti Pank reduced the systemic risk buffer for the commercial banks from 1 per cent to 0 per cent to release liquidity in the banking sector, with a total impact estimated at about €110 million. The Eesti Pank also announced that it would allocate three-quarters of its 2019 profits, equivalent to €18.9 million, to support the state budget in addressing the Covid-19 crisis.

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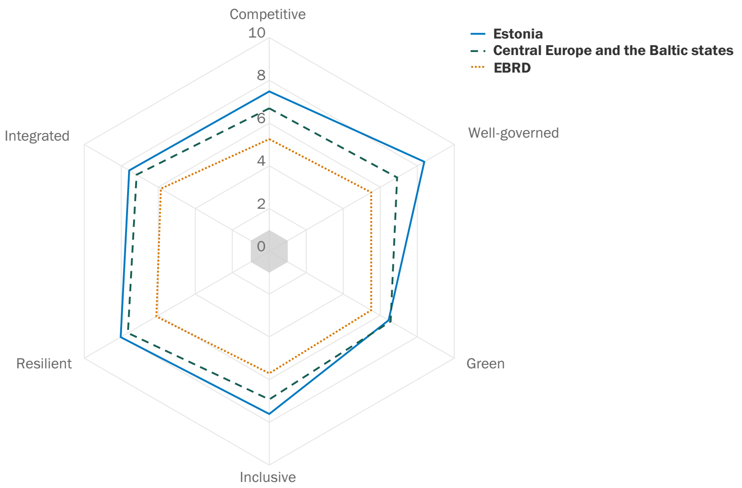
Assessment of transition qualities (1-10)



Structural reform developments

The parliament fully transposed the fifth EU Anti-money laundering Directive. The government initiated the Act on Amendments to the Money Laundering and Terrorist Financing Prevention Act, which was passed by parliament in June 2020. The act aims to strengthen the prevention of money laundering, and it transposes the remaining EU recommendations into national law. The key provisions are focused on whistle-blower protection, the development of a register of bank accounts which can be accessed by the Financial Intelligence Unit (the agency responsible for the supervision and prevention of money laundering), and more information exchange between entities. In addition, the Financial Intelligence Unit will become an autonomous institution under the Ministry of Finance. The EC and the IMF, however, have suggested that gaps remain in the capacity of the Financial Supervision Authority and in the overall implementation of regulation, such as the number of onsite inspections.

The insolvency framework reform is progressing. The government has prioritised the reform of the insolvency regime and proposed amendments, which passed the first reading in parliament in June 2020. The revised bill established, among other things, an insolvency service, greater specialisation of courts and more transparent remuneration of trustees. Resolving insolvency is the second-lowest ranked dimension for Estonia in the World Bank's *Doing Business 2020* report, and institutions such as the EC, IMF and OECD have all highlighted the need to streamline the restructuring process, debt discharge and, ultimately, to transpose the EU Restructuring and Insolvency Directive.

The pension system has been amended, stimulating consumption but possibly holding back capital markets development. Under the new rules, joining and leaving the second pillar will be voluntary. Requests to be released from payment will be accepted starting January 2021, while the payments will become voluntary as of October 2020. The change may result in a short-term consumption stimulus, but it will likely hold back capital markets development.

The gender pay gap is being addressed. The authorities have initiated several measures aimed at decreasing the gender pay gap, which reached an estimated 22.7 per cent in 2018 according to Eurostat. As of July 2020, parental leave will increase from 10 to 30 days, while the leave period will be flexible for the first three years. This is to help women return to work by encouraging a more flexible leave system. These two regulations are the final provisions of the reform of the parental leave and benefits system, which was approved at the end of 2017 and introduced gradually from 2018 to 2020.