ESTONIA: A momentary dip, rather than recession

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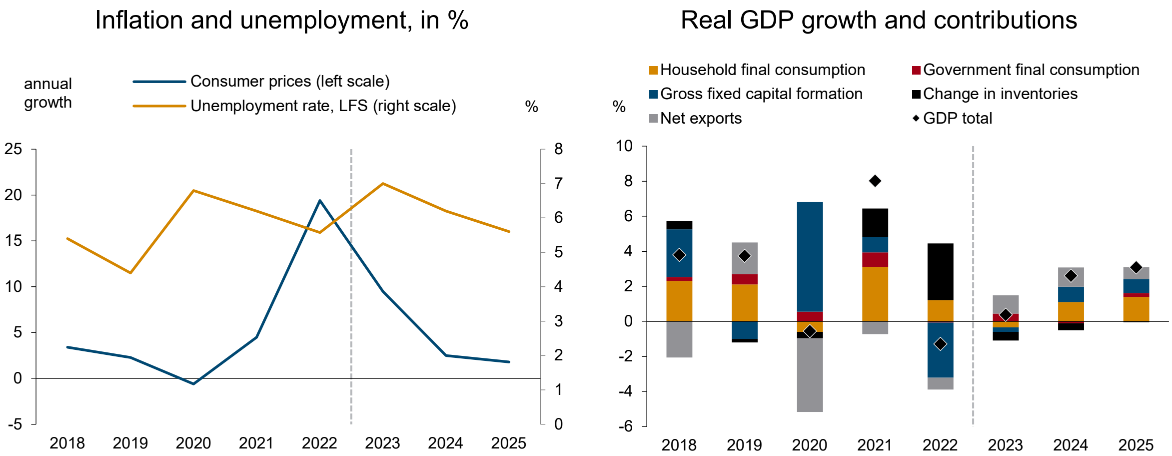
The anticipated economic decline – driven by severe inflation and weakening foreign demand – did indeed materialise in Q4 2022. However, economic prospects are not that grim, as inflation is slowing and consumption is gradually recovering. Moreover, economic activity in those sectors that are less reliant on imports of raw materials remains strong. Yet two major risk factors overshadow the outlook – the reduced export competitiveness of Estonian firms and a deepening systemic imbalance between budget revenue and expenditure.

Figure 5.7 / Estonia: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

As anticipated, economic growth was hit by high inflation in the second half of 2022, leading to overall economic decline of 1.3% for the year; the main factors were a poorly performing export sector and slackening domestic demand. Yet, prices are rising more slowly, business activity remains resilient and the labour market continues strong – all suggesting that the economic dip will be short lived. Nonetheless, sluggish domestic and foreign demand means that any marked recovery will only get under way in the second half of 2023, as purchasing power begins to revive. The economy is projected to grow by only a modest 0.4% in 2023, followed by 2.6% in 2024 and 3.1% in 2025.

As during the pandemic times, the performance of different sectors varied dramatically last year, yet the current crisis led to the best and the worst performers switching places. Whereas the pandemic hit tourism, accommodation, the food sector and agriculture, last year saw the ongoing revival of those sectors; indeed, despite the rocketing inflation and dwindling purchasing power, they made a non-negligible positive contribution to economic growth. By contrast, the business services and IT sectors – the whales that buoyed up the Estonian economy throughout the pandemic – contributed to the economy's contraction in 2022.

Inflation is being brought under control, but there is a long way to go before it reaches the pre-crisis level. Having peaked at 25% in August 2022, inflation slowed in the second half of 2022 and was down to 15.3% by March 2023. This was mainly thanks to gas and electricity prices returning to their pre-war levels – a result both of falling market prices and government measures to make electricity, gas and heating more affordable. Reduced domestic and foreign demand in Q4 2022 narrowed firms' ability to raise prices, while climbing interest rates made borrowing more expensive for businesses and households and put the brakes on inflation in the first months of 2023 Inflation is expected to slow further in the coming months (largely due to the high reference base) and will average around 9.5% in 2023; this will be followed by a decline to 2.5% in 2024 and 1.8% in 2025.

Estonian companies are finding it harder to maintain their competitiveness on the global market. The heavy price pressure and interruptions to supply have been further exacerbated by the lack of state support for enterprises to offset the adverse effects of the energy crisis. Whereas in many other EU countries – including Estonia's main competitors – governments have introduced business-support schemes to smooth the energy crisis and supply shortages, Estonian enterprises have had to deal with the crisis largely on their own.

Rising prices, the uncertainty caused by the war and declining demand abroad led to a slump in export activity in the second half of 2022. Furthermore, many exporting sectors faced prices for raw materials and energy that were far higher than their competitors had to contend with, and this undermined the competitiveness of Estonian firms. The slowdown in goods exports pushed the current account into a 0.5% GDP deficit in Q4 2022, and the downward export dynamics have lasted through the first months of 2023. Exports of services remained strong in 2022 and provided much support to the current account, with IT, other business services and transport services accounting for 70% of service exports in 2022. Still, the full-scale recovery of exports – which used to be generally one of the drivers of economic revival in Estonia – cannot be relied upon this time, as the competitiveness of Estonian firms (especially in manufacturing) is under severe threat, with exports projected to decline by 1.5% in 2023. Subsequent years should see some revival in foreign trade.

The investment outlook for 2023 is rather bleak, due to the overall slowdown in business activity, rising interest rates and persistent uncertainty. Yet investment activity has varied dramatically across the sectors, with investments in energy efficiency remaining consistently high throughout the year. Corporate investments will likely improve in the second half of 2023, reflecting declining inflation, economic revival, stabilising energy prices and an easing of supply bottlenecks. Yet higher interest rates will rein in investment activity. Hence, one should not expect any major contribution of investments to economic revival in 2023.

The previously strong private consumption lost momentum in the second half of 2022 and will likely stay low throughout the first half of 2023, before gradually recovering. Despite all the uncertainty and the rising prices last year, consumption remained solid throughout the first two quarters of 2022, based on steady wage growth (especially in the private sector) and private savings buffers. However, it fell in the last quarters of 2022, as consumer price inflation peaked, savings were largely depleted and borrowing became more expensive. In 2023, the development of consumption will be reinforced by various government support schemes, such as increased child and family benefits and a rise in both pensions and public-sector wages. Falling inflation will also help to buoy up consumption. However, private spending will be curbed by the rising cost of housing loans (which will reduce further the purchasing power of households with variable mortgages) and by the fact that savings were largely exhausted in 2022. Thus, private consumption will post a modest decline of 0.7% in 2023, with a subsequent revival of 2.3% in 2024 and 2.9% in 2025, built on a strong labour market and diminishing inflation.

The labour market remained strong through 2022, with nominal wages growing at 9.2% year on year and unemployment remaining at 5.4% in Q4 2022; this benefited domestic demand, though it exerted upward pressure on inflation. A slowdown in business activity will reduce labour demand in the first half of 2023, restraining wage growth and boosting joblessness. Unemployment will also be fuelled by the Ukrainian refugees who are entering the labour market this year. Over 40,000 Ukrainians fleeing the war had registered in Estonia by the end of 2022, but as of March 2023 only around 10,000 had joined the labour market. This suggests that a large share of those refugees will start looking for a job this year. Unemployment will likely reach around 7.0% in 2023, dropping to 6.2% in 2024 and to 5.6% in 2025.

Exceptionally high tax receipts aided the state budget in 2022, yet the fiscal position will deteriorate this year. High rates of inflation and an economy that was still performing relatively well brought the state budget exceptionally high tax revenues in 2022. These will largely be used in 2023 to finance mounting state expenditure – likely to grow substantially on account of increased spending on defence, welfare and family benefits, a one-off pension rise and a not inconsiderable increase in public-sector wages. Meanwhile, a rise in the tax-free income threshold and the overall economic downturn will reduce the tax inflow in 2023. We forecast a widening of the budget deficit in 2023, to 4% of GDP.

Tight fiscal discipline and the anticipated economic recovery will likely prevent this budget deficit growing any more, but it will narrow only slowly – reaching around 3% in 2025. Whereas some of the state measures aimed at supporting consumers and boosting private consumption – such as the public-sector wage increase – will have just a short-lived effect on government spending, other measures (including the raising of the tax-free income threshold) will have long-lasting repercussions for the state budget. Yet the planned increases in VAT and in income tax (in 2024 and 2025, respectively) will yield additional state revenue in the coming years. For a country with long-established strict fiscal discipline and historically very low external debt, the current fiscal imbalance is a major topic of debate and will likely remain so for the newly formed government coalition.

Table 5.7 / Estonia: Selected economic indicators

	2019	2020	2021	2022 1)	2023	2024	2025
						Forecast	
Population, th pers., average	1,327	1,330	1,331	1,345	1,350	1,349	1,347
Gross domestic product, EUR m, nom.	27,765	27,465	31,445	36,181	39,800	41,900	44,000
annual change in % (real)	3.7	-0.6	8.0	-1.3	0.4	2.6	3.1
GDP/capita (EUR at PPP)	25,780	25,850	28,840	30,620	.	.	.
Consumption of households, EUR m, nom.	13,451	13,171	14,618	17,504	.	.	.
annual change in % (real)	4.4	-1.2	6.5	2.6	-0.7	2.3	2.9
Gross fixed capital form., EUR m, nom.	7,056	8,563	9,076	9,161	.	.	.
annual change in % (real)	-3.7	24.7	2.8	-10.9	-1.0	3.4	3.2
Gross industrial production							
annual change in % (real)	6.9	-3.0	13.3	-2.0	1.0	4.2	3.5
Gross agricultural production							
annual change in % (real)	22.8	0.0	-4.9	3.9	.	.	.
Construction industry							
annual change in % (real)	5.8	-6.1	9.4	-1.2	.	.	.
Employed persons, LFS, th, average 2)	671.3	656.6	654.2	680.9	680	690	700
annual change in %	1.0	-2.2	-0.5	4.1	0.5	1.2	0.9
Unemployed persons, LFS, th, average 2)	31.3	47.9	43.1	40.2	51	46	42
Unemployment rate, LFS, in %, average 2)	4.4	6.8	6.2	5.6	7.0	6.2	5.6
Reg. unemployment rate, in %, eop 3)	5.3	8.3	6.8	7.7	.	.	.
Average monthly gross wages, EUR	1,407	1,448	1,548	1,685	1,930	2,090	2,210
annual change in % (real, gross)	5.0	3.4	2.1	-8.8	4.5	5.6	4.0
Average monthly net wages, EUR	1,150	1,185	1,266	1,379	1,590	1,720	1,820
annual change in % (real, net)	5.1	3.5	2.0	-8.8	5.0	5.8	4.1
Consumer prices (HICP), % p.a.	2.3	-0.6	4.5	19.4	9.5	2.5	1.8
Producer prices in industry, % p.a.	-0.6	-3.5	17.2	36.0	9.0	2.4	1.7
General governm. budget, EU def., % of GDP							
Revenues	39.5	39.4	39.0	45.0	41.0	42.1	42.7
Expenditures	39.4	44.9	41.5	47.0	45.0	45.4	45.7
Net lending (+) / net borrowing (-)	0.1	-5.5	-2.4	-2.0	-4.0	-3.3	-3.0
General gov. gross debt, EU def., % of GDP	8.5	18.5	17.6	19.5	21.8	20.8	19.6
Stock of loans of non-fin. private sector, % p.a.	3.3	4.8	7.5	11.7	.	.	.
Non-performing loans (NPL), in %, eop	0.5	0.4	0.2	0.2	.	.	.
Central bank policy rate, % p.a., eop 4)	0.00	0.00	0.00	2.50	.	.	.
Current account, EUR m	658	-272	-568	-790	280	750	630
Current account, % of GDP	2.4	-1.0	-1.8	-2.2	0.7	1.8	1.4
Exports of goods, BOP, EUR m	13,317	13,290	16,367	20,092	19,100	20,750	21,700
annual change in %	5.8	-0.2	23.2	22.8	-4.9	8.6	4.6
Imports of goods, BOP, EUR m	14,245	13,533	17,662	22,759	21,670	22,250	22,900
annual change in %	3.1	-5.0	30.5	28.9	-4.8	2.7	2.9
Exports of services, BOP, EUR m	7,197	5,736	8,254	10,845	12,310	12,900	13,800
annual change in %	7.7	-20.3	43.9	31.4	13.5	4.8	7.0
Imports of services, BOP, EUR m	5,154	5,470	7,073	8,382	9,450	10,300	11,700
annual change in %	8.6	6.1	29.3	18.5	12.7	9.0	13.6
FDI liabilities, EUR m	2,708	3,122	6,169	1,517	.	.	.
FDI assets, EUR m	1,634	253	5,558	2,086	.	.	.
Gross reserves of CB excl. gold, EUR m	1,256	1,615	2,081	2,068	.	.	.
Gross external debt, EUR m	21,135	24,382	26,630	30,531	34,300	35,200	36,400
Gross external debt, % of GDP	76.1	88.8	84.7	84.4	86.3	84.0	82.8

1) Preliminary and wiiw estimates. - 2) From 2021 the new LFS methodology is applied in line with the Integrated European Social Statistics Regulation (IESS). - 3) In % of labour force (LFS). - 4) Official refinancing operation rate for euro area (ECB).

Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.