ESTONIA: At full capacity – heading for a soft landing

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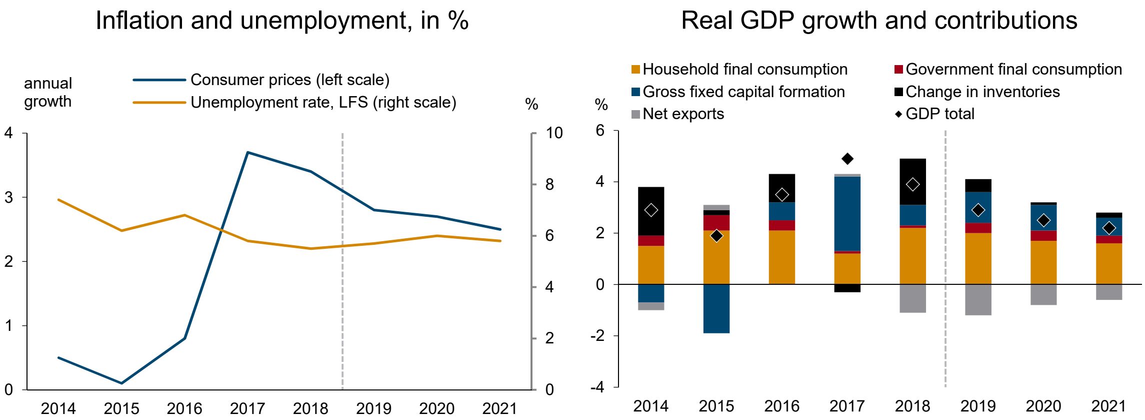
Investment activity will revive in 2019-2020, induced by inflows of EU funds and increased capital spending for machinery by enterprises. Household consumption, backed by a considerable rise in employment and incomes, continues to be a strong driver of growth. However, given the weakened outlook for external demand, exports will develop at a declining pace in the coming years. We project GDP to grow at lower rates of 2.9% in 2019 and 2.5% in 2020, while even diminishing to 2.2% in 2021.

Figure 6.7 / Estonia: Main macroeconomic indicators



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

In 2018 export growth was still rather lively, however mostly driven by increases in a few particular goods categories. The high oil price supported demand for Estonian shale oil – exports almost doubled in nominal terms in 2018 compared to 2017. For certain, in 2019 we will see declining exports of this basic materials sector. The Estonian wood manufacturers still benefited last year from stable growth of housing construction in Finland and Sweden. In 2019, however, the price decline of real estate in Sweden will be followed by a fall in investments there and thus deteriorating prospects for the Estonian wood industry. Exports of the electronics producers are developing at a good pace. Their hopes rely on a swift spread of the 5G mobile networks in Europe, which should increase demand for network equipment from Nokia and Ericsson and their suppliers in Estonia in the coming years. In general, we expect a slowdown in economic activity in the export destinations of Estonia. A slight increase of import demand in Russia should help to keep Estonian goods exports afloat. However, only about a quarter of the exports to Russia are of Estonian origin, the rest is transit trade. Fast rising wages in Estonia are putting pressure on exporting firms particularly in the low-productive sectors of manufacturing. The worldwide market shares of Estonian exporters have been stagnating in the past

2-3 years and are likely to decline given the ongoing rise in unit labour costs. Thus a contraction of the Estonian manufacturing sector in general is probable in the coming years. Overall, we expect real growth in goods exports to level off in 2019-2021. Given swiftly rising household incomes, imports will keep on expanding more strongly than exports.

After a slowdown in 2018, growth in investment activity will revive in 2019 and 2020. Public infrastructure investment, supported by inflows from EU funds, will develop swiftly in 2019 and 2020. This includes the construction of the main terminals of Rail Baltica, the high-speed train project connecting the Baltics with the Central European network, and the extension of the Tallinn-Tartu highway. After 2020 public investments will rise at a slower pace when the end of the EU funds 2014-2020 programming period is approaching. Investments of private enterprises in machinery will increase more swiftly this year after stagnating in 2018. Strong growth in wages and very low interest rates are still driving an increase in mortgages to households and thus investment in housing. Real estate prices already increased less rapidly towards the end of 2018 and declining building permits granted show that a levelling off in dwelling construction is going to take place from 2019 onwards.

In 2018, the unemployment rate continued to fall gradually towards 5.4% (according to LFS data) on average, but will rise slightly during the forecast period. The favourable economic developments resulted also in an increase in employment by 1% last year. Due to the work ability reform, introduced in 2016, people having received work incapacity pensions in the past now have to look for jobs and take part in public work activation measures in order to be eligible for benefits. The scheme is expected to increase the labour force by about 1.6% towards 2020 compared to 2017. However, the reform will also trigger a slight increase in the unemployment rate in the coming two years. Moreover, in 2020 at the latest we expect a reduction in jobs in the construction sector. Thereafter a continuous decline in the workforce is going to take place, even though immigration is likely to increase slightly. The employment rate will thus rise even further, which at 76% (among 15-64 year-olds as of Q4/2018) is already at the level of the Scandinavian countries (which is the highest in the EU). In the 65-74 age group, 27% of the population is still working, which is much more than anywhere else in the EU28 (average 10% in Q4/2018).

Given the tight labour market situation, wages will continue to rise strongly in the next few years. Real gross wages picked up by another 3.8% year on year in 2018, resulting in private consumption to increase by more than 4% last year. Household incomes are bolstered by a further 8% increase in the minimum wage, effective from January 2019, to EUR 540 per month. Forward-looking consumer confidence indicators are still very positive and retail trade and credit statistics indicate favourable sentiment among consumers. Entrepreneurs however expect some cooling not only of external but also domestic demand already this year. Consumer price inflation will continue to decline towards 2.8% in 2019. Although rising wages keep core inflation above 2%, energy prices will fall and the rise in excise taxes will contribute only little to inflation in the coming two years.

On 19 February 2019 the Estonian financial supervisor instructed Danske Bank Estonia to close down its business within 8 months. The Estonian branch of the Danish institute, being an important player in the Nordic banking sector, failed to prevent suspected money laundering of about USD 230 billion in the years 2007 to 2015 mostly from non-residents. In December 2018, 10 former employees of Danske Estonia were arrested. Following pressure from the Estonian financial supervisory authority, Danske had already withdrawn step-by-step from the Estonian market from 2015 onwards, when it stopped providing services to private individuals and non-residents. Danske recently announced also to close its operations in Russia, Latvia and Lithuania.

On 3 March 2019 parliamentary elections were held in Estonia. The coalition government of Prime Minister Jüri Ratas lost its majority in the parliament, since the support for the junior partners of the leading Centre Party, the Social Democrats and the conservative Pro Patria, fell strongly. The next Prime Minister will most probably be Kaja Kallas, the daughter of the former European Commissioner and Estonian Prime Minister Siim Kallas. Her liberal Reform Party attained a third of the seats in the parliament. The biggest change in the political landscape was the strong gain in votes of the Conservative People's Party, a nationalist right-wing movement strongly opposing immigration that came in third with 18% of the votes. However, neither 'Centre' nor 'Reform' are willing to go into coalition with them. For 2019 the Estonian government budget foresees a continuation of the fiscal surplus path without further tax changes planned. Above-average expenditure growth will occur for defence and the health and welfare sectors, including an increase in child benefits. Subsidies will be raised for public transport in order to expand the scheme of free public transport, which was first introduced in the capital city of Tallinn in 2013 and is run in 11 of 15 counties now. The medium-term fiscal strategy of the Estonian government foresees a general budget surplus of 0.3% on average and thus to bring the level of public debt down to 5% of GDP over the coming four years.

Following the gradual deterioration in the external environment we slightly reduced our prospects for the Estonian economy compared to our previous forecast; real GDP is expected to grow by 2.9% in 2019. The relatively tight situation in the labour market will keep wage growth high, and will thus also bolster private consumption over the coming two years. While investment growth lost steam in 2018, public infrastructure projects will result in a revival in 2019-2020. In the medium term, however, we expect export growth to fall while import demand will remain strong due to rising household incomes. As a result, we forecast a decline in GDP growth rates to 2.5% and 2.2% for 2020-2021 respectively.

Table 6.7 / Estonia: Selected economic indicators

	2014	2015	2016	2017	2018 [1)]	2019	2020	2021
							Forecast	
Population, th pers., average	1,315	1,315	1,316	1,317	1,320	1,325	1,328	1,330
Gross domestic product, EUR mn, nom.	20,061	20,652	21,683	23,615	25,200	26,900	28,300	29,600
annual change in % (real)	2.9	1.9	3.5	4.9	3.9	2.9	2.5	2.2
GDP/capita (EUR at PPP)	21,400	21,900	22,500	23,600	24,800	.	.	.
Consumption of households, EUR mn, nom.	9,835	10,243	10,777	11,448	12,300	.	.	.
annual change in % (real)	3.0	4.3	4.3	2.5	4.6	4.2	3.5	3.2
Gross fixed capital form., EUR mn, nom.	5,139	4,872	4,978	5,770	6,100	.	.	.
annual change in % (real)	-2.6	-7.6	2.9	12.5	3.3	5.0	4.0	3.0
Gross industrial production								
annual change in % (real)	3.9	0.3	3.4	7.7	4.2	3.5	3.0	2.5
Gross agricultural production								
annual change in % (real)	4.6	8.7	-17.2	6.5	-6.1	.	.	.
Construction industry								
annual change in % (real)	-2.1	-3.5	4.6	17.7	18.0	.	.	.
Employed persons, LFS, th, average	624.8	640.9	644.6	658.6	665.0	668	672	670
annual change in %	0.6	2.6	0.6	2.2	1.0	0.5	0.6	-0.3
Unemployed persons, LFS, th, average	49.6	42.3	46.7	40.3	38.7	40	43	41
Unemployment rate, LFS, in %, average	7.4	6.2	6.8	5.8	5.5	5.7	6.0	5.8
Reg. unemployment rate, in %, eop [2)]	4.4	4.7	4.4	4.8	4.8	.	.	.
Average monthly gross wages, EUR	1,005	1,065	1,146	1,226	1,310	1,390	1,470	1,550
annual change in % (real, gross)	6.0	6.5	7.4	3.5	3.5	3.3	3.2	3.0
Average monthly net wages, EUR	799	859	924	985	1,050	1,110	1,170	1,230
annual change in % (real, net)	5.7	8.0	7.4	3.0	3.2	3.0	3.0	2.7
Consumer prices (HICP), % p.a.	0.5	0.1	0.8	3.7	3.4	2.8	2.7	2.5
Producer prices in industry, % p.a.	-2.1	-2.5	-0.9	3.3	3.9	2.6	2.5	2.2
General governm. budget, EU-def., % of GDP								
Revenues	38.5	39.7	39.1	38.9	39.5	39.5	39.2	39.5
Expenditures	37.8	39.6	39.5	39.3	39.5	39.3	39.1	39.4
Net lending (+) / net borrowing (-)	0.7	0.1	-0.3	-0.4	0.0	0.2	0.1	0.1
General gov.gross debt, EU def., % of GDP	10.5	9.9	9.2	8.7	8.5	7.8	7.5	7.0
Stock of loans of non-fin.private sector, % p.a.	2.6	4.8	6.6	0.7	5.1	.	.	.
Non-performing loans (NPL), in %, eop	1.5	1.1	1.0	0.8	0.5	.	.	.
Central bank policy rate, % p.a., eop [3)]	0.05	0.05	0.00	0.00	0.00	.	.	.
Current account, EUR mn	162	381	425	751	310	360	361	362
Current account, % of GDP	0.8	1.8	2.0	3.2	1.2	1.3	1.3	1.2
Exports of goods, BOP, EUR mn	11,026	10,689	11,294	12,022	12,600	13,100	13,550	14,000
annual change in %	0.5	-3.1	5.7	6.4	4.8	4.0	3.4	3.3
Imports of goods, BOP, EUR mn	12,019	11,571	12,055	12,839	13,800	14,400	15,050	15,600
annual change in %	1.1	-3.7	4.2	6.5	7.5	4.3	4.5	3.7
Exports of services, BOP, EUR mn	5,385	5,284	5,532	6,054	6,500	6,950	7,400	7,800
annual change in %	7.9	-1.9	4.7	9.4	7.4	6.9	6.5	5.4
Imports of services, BOP, EUR mn	3,678	3,575	3,888	4,162	4,600	4,900	5,150	5,450
annual change in %	4.1	-2.8	8.8	7.0	10.5	6.5	5.1	5.8
FDI liabilities, EUR mn	1,331	-654	845	1,403	1,700	.	.	.
FDI assets, EUR mn	847	-521	341	543	300	.	.	.
Gross reserves of NB excl. gold, EUR mn	352	373	325	279	651	.	.	.
Gross external debt, EUR mn	19,040	19,163	19,162	19,512	19,900	20,400	20,900	21,300
Gross external debt, % of GDP	94.9	92.8	88.4	82.6	79.0	76.0	74.0	72.0

1) Preliminary and wiiw estimates. - 2) In % of labour force (LFS). - 3) Official refinancing operation rate for euro area (ECB).

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