ESTONIA: Full-speed growth riding on massive investment

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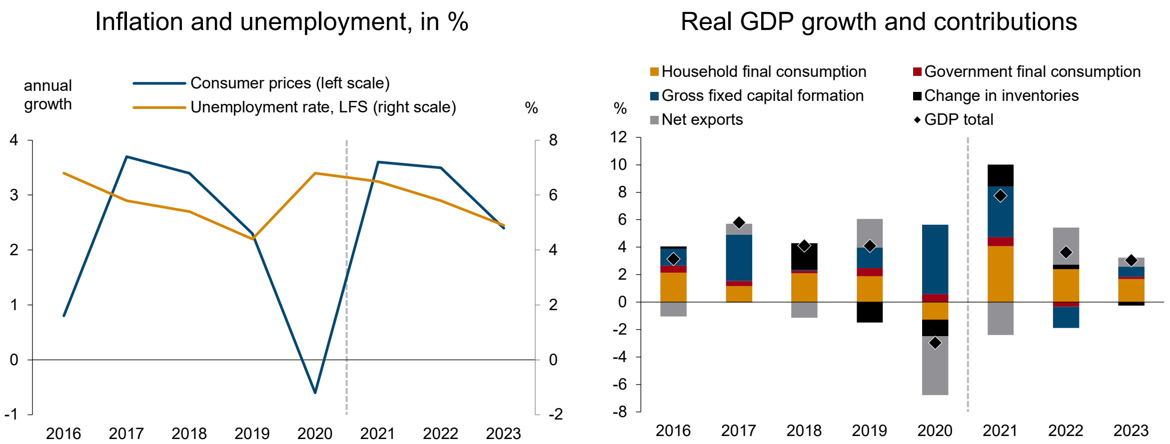
The first half of 2021 showed Estonia to be another post-pandemic success story. Record high investment flooded into the ICT sector, while strong purchasing power and a rapid revival in foreign trade are the pillars of economic growth. We expect the economy to grow by 7.8% in 2021. Even by the middle of the year, the country's pre-pandemic level of output had been exceeded. Future growth will be driven by production expansion, steady consumer demand, rising investment, a strengthening position on the foreign market and further digital transformation.

Figure 4.7 / Estonia: Main macroeconomic indicators



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

The powerful economic growth of the first half of 2021 exceeded all expectations. The economy commenced its dynamic recovery, with 4.3% quarter-on-quarter and 13.9% year-on-year GDP growth in Q2 2021, and the economic outlook for the coming years looks brighter than was predicted in spring 2021. The lockdown and the stringent restrictions imposed from March until May did nothing to retard the recovery: quite the reverse – economic growth proceeded full speed ahead, and the pre-pandemic levels of output were left trailing in its wake.

Business activity in the first half of 2021 signalled greater immunity of companies to the restrictions imposed. Companies outstripped pre-pandemic performance, as business learned to adjust. With the pandemic in full swing for a year and a half, adaptation is essential to survival – especially for service industries and retail trade. The last round of restrictions showcased the great capacity of businesses to adjust and stay afloat, mainly via an upswing in e-commerce and the digitalisation of operations. The climbing indexes of economic activity based on business surveys suggest rising confidence among business owners.

The overall positive dynamics are marred a little by the uneven speed of recovery across the economic sectors, as the powerful bounce-back is driven by those sectors least affected by the crisis. Through thick and thin, the ICT sector has remained a solid pillar of the Estonian economy: for a time, it largely drove the recovery, maintaining employment and wage growth, attracting massive investment and making a substantial contribution to the state budget revenues. However, in contrast to 2020, so far in 2021 the ICT sector has not been the only sector driving the recovery: business services, transportation and construction have been growing steadily since the beginning of the year. The retail sector posted a 14.8% increase (quarter on quarter) in Q2 2021, encouraged by booming e-commerce during the spring wave of the pandemic. However, some sectors are still lagging far behind the pre-crisis levels. The accommodation and food services sector saw a 40% drop last year, and it is unlikely to recover before the end of this year. It is a similar story with the leisure and support activities sectors.

The massive surge in investment at the end of last year persisted in 2021. With production capacity fully utilised in response to steadily rising demand, investment is crucial for further production expansion. The upswing in inward foreign direct investment in the equity of Estonian companies reached a record EUR 3bn in Q2 2021. Investments in fixed assets reached 60% year-on-year growth in that same quarter. Huge corporate investments, among other things, flooded into the biotechnology sector and a newly opened factory producing chemicals for COVID-19 tests. Unlike the previous year, investments in fixed assets in manufacturing, construction and agriculture climbed in the first two quarters of 2021. Savings accumulated during the pandemic and pension reform – designed to shift pension provision from the mandatory to the voluntary second pillar – provided a strong tailwind for private investments: these grew in Q2 2021 by 13% (seasonally adjusted, quarter on quarter). The investment capacity of people was remarkably high throughout the crisis, and is increasing as the pandemic fades, thanks to the extra EUR 50-70m added to private savings monthly since February 2021, as well as to the pension reform (resulting in over EUR 1bn released in the first half of 2021) and the sound investment capacity of the banks. The market in real estate has undergone an unprecedented boom, and private housing loans last year reached record levels. Investments will remain a core pillar of growth in the next few years.

Domestic demand is thriving, reaching 25.2% growth, year on year, in Q2 2021, thanks to increased purchasing power and improved consumer and producer confidence. With extra household savings and money withdrawn from the second pension pillar, private consumption will thrive once the restrictions are eased further and consumption options become unlimited. Private consumption is expected to grow by 8.5% this year and by 5.0% in 2022. However, the dismantling of the mandatory second pillar seems to be a zero-sum game, since it merely brings forward future consumption, and thereby will reduce the economy’s long-run growth performance.

An improved external environment has revived foreign demand and raised export receipts by over a third, compared to 2020. A boost in foreign trade in Q2 2021 was based on increased external demand for production inputs, recovering supply chains and restrictions being lifted worldwide. The growth in exports year on year in Q2 2021 was 36.5% for goods and 46.2% for services. The base effect is most apparent in services exports, as in 2020 they were hit harder in Estonia than in the other Baltic and Nordic countries: they declined by 21%, and this figure was moderated only by steadily high exports of ICT and other business services. Imports increased in both goods and services in the first half of

2021, with the latter largely driven by a huge purchase of computer services related to VW Group operations. We expect both exports and imports to grow substantially in 2021, with the increase reaching 15.5% for exports and 19.0% for imports; this will be followed by a gradual convergence with pre-pandemic growth by 2023.

With energy prices increasing further and mounting demand pressure, consumer price inflation reached 5% in August 2021. Yet it is not the massive rise in energy prices alone that has led to the reappearance of inflation: the prices of consumer durables and services (which started to rise from a low base), as well as the cost of food and industrial goods (mainly construction materials, home furnishing and used cars) also soared over the summer. With booming domestic demand and production capacity exploited to the limit, producers may face difficulties in keeping up with demand, which will create extra pressure on prices. As the energy price increase is expected to slow down in the second half of the year, we project inflation of 3.6% for 2021, with a gradual decline to 2.4% by 2023.

Structural changes are looming on the labour market, as the revival in employment and wage growth remain uneven across sectors. The spring wave of the pandemic caused no deterioration in the employment situation: unemployment declined from 7.1% in Q1 2021 to 6.9% in Q2 2021, and is likely to drop to pre-pandemic levels by 2023. As business activity flourished, labour shortages reasserted themselves: it is mostly employers in construction, industry and the service sector that have noticed a lack of workforce. Disproportionate economic decline and recovery rates across sectors have resulted in substantial labour reallocation across industries, and this change may prove lasting. Average wages were up 4.4% quarter on quarter (and 7.3% year on year) in Q2 2021, as a result of a recovery in working hours and a big wage boost in ICT and the healthcare sector. Yet future wage growth is expected to remain polarised, with low-earning workers restrained by an abandoned minimum wage increase.

The odds of the budget deficit narrowing to 1% of GDP by 2023 have increased, as the economy continues to recover strongly. The government support launched in 2020 and subsequent support measures introduced in 2021, coupled with high public healthcare spending and social transfers resulted in a cumulative budget deficit of 3.4% of GDP in the first half of 2021. As the economy has commenced a period of rapid growth, tax receipts are increasing; on the assumption that any increase in public spending is limited, fiscal balance may be achieved by the end of the forecast horizon. Since the relative contribution of production and consumption taxes is higher than in other EU countries, the state budget will reap the benefits of reviving private consumption and production in the coming years.

Every cloud has a silver lining – for Estonia, it is the country's further digital transition. As one of the most digitally advanced economies in the EU, Estonia experienced a further boost in digitalisation as a consequence of the pandemic. E-commerce, well-running digital services and the digitalisation of business operations converted the limitations posed by the pandemic into opportunities to expand and advance the e-economy. To facilitate this further, a large share of the European Union support funding – around EUR 3bn, will be channelled into further digital transformation in the coming years.

External factors were responsible for much of the economic downturn in 2020, and these will remain important for economic growth in subsequent years. Given the country's outstandingly good economic performance in the first half of 2021 – driven by strong domestic demand, the increased purchasing power of people, a massive influx of investment and a labour market revival – we project GDP growth of 7.8% in 2021, followed by 3.6% in 2022 and 3.0% in 2023. However, the forecast carries a good deal of uncertainty that is related to the external environment in 2022-2023. The reliable operation of supply chains is a crucial factor in further growth. With domestic demand climbing and foreign trade picking up, production capacity is nearing its historical peak, and supply difficulties may hinder further business growth. As a result, in the next few years the government agenda needs to focus on resolving supply difficulties, reallocating the workforce in response to looming labour shortages, and keeping inflation under control.

Table 4.7 / Estonia: Selected economic indicators

	2018	2019	2020 [1]	2020	2021	2021	2022	2023
				January-June			Forecast	
Population, th pers., average	1,322	1,327	1,329	1,319	1,325	1,340	1,342	1,342
Gross domestic product, EUR m, nom.	25,818	27,732	26,835	12,718	14,120	30,000	32,200	34,000
annual change in % (real)	4.1	4.1	-3.0	-3.8	8.5	7.8	3.6	3.0
GDP/capita (EUR at PPP)	24,570	25,760	25,380	.	.	.	.	.
Consumption of households, EUR m, nom.	12,522	13,340	12,885	6,217	6,620	.	.	.
annual change in % (real)	4.3	3.9	-2.7	-4.1	4.7	8.5	5.0	3.5
Gross fixed capital form., EUR m, nom.	6,376	7,052	8,233	2,905	4,544	.	.	.
annual change in % (real)	0.2	6.1	19.9	-8.1	56.8	12.0	-5.0	2.4
Gross industrial production								
annual change in % (real)	4.7	6.7	-6.1	-11.2	7.1	6.2	5.9	4.0
Gross agricultural production								
annual change in % (real)	-6.3	22.8	-2.2	.	.	.	.	.
Construction industry								
annual change in % (real)	12.3	5.8	-6.1	-1.8	6.1	.	.	.
Employed persons, LFS, th, average [2]	664.7	671.3	656.6	657.1	645.6	670	680	690
annual change in %	0.9	1.0	-2.2	-1.2	.	1.5	1.2	0.8
Unemployed persons, LFS, th, average [2]	37.7	31.3	47.9	42.2	48.1	47	42	36
Unemployment rate, LFS, in %, average [2]	5.4	4.4	6.8	6.1	7.0	6.5	5.8	4.9
Reg. unemployment rate, in %, eop [3]	4.8	5.3	8.3	7.8	7.6	.	.	.
Average monthly gross wages, EUR	1,310	1,407	1,448	1,419	1,506	1,590	1,760	1,920
annual change in % (real, gross)	3.8	5.0	3.4	2.6	4.2	5.8	6.9	6.7
Average monthly net wages, EUR	1,070	1,150	1,185	1,161	1,232	1,300	1,410	1,510
annual change in % (real, net)	5.0	5.1	3.5	2.8	4.2	5.8	4.9	4.8
Consumer prices (HICP), % p.a.	3.4	2.3	-0.6	0.0	1.7	3.6	3.5	2.4
Producer prices in industry, % p.a.	3.9	-0.6	-3.5	-4.8	8.3	3.3	2.5	2.2
General governm. budget, EU-def., % of GDP								
Revenues	38.9	39.5	40.7	.	.	40.1	41.0	41.2
Expenditures	39.5	39.5	45.7	.	.	44.1	43.0	42.2
Net lending (+) / net borrowing (-)	-0.6	0.1	-5.0	.	.	-4.0	-2.0	-1.0
General gov.gross debt, EU def., % of GDP	8.2	8.6	18.5	.	.	20.0	18.5	15.0
Stock of loans of non-fin.private sector, % p.a.	5.1	3.3	4.8	1.9	5.5	.	.	.
Non-performing loans (NPL), in %, eop	0.5	0.5	0.4	0.5	0.4	.	.	.
Central bank policy rate, % p.a., eop [4]	0.00	0.00	0.00	0.00	0.00	.	.	.
Current account, EUR m	206	700	-69	665	-952	-1,120	-150	-70
Current account, % of GDP	0.8	2.5	-0.3	5.2	-6.7	-3.7	-0.5	-0.2
Exports of goods, BOP, EUR m	12,593	13,340	13,387	6,212	7515	14,850	15,200	15,600
annual change in %	5.3	5.9	0.4	-8.0	21.0	10.9	2.4	2.6
Imports of goods, BOP, EUR m	13,816	14,270	13,535	6,288	8129	16,300	16,200	16,600
annual change in %	7.3	3.3	-5.2	-11.4	29.3	20.4	-0.6	2.5
Exports of services, BOP, EUR m	6,634	7,195	5,713	2,767	3358.6	7,000	7,300	7,560
annual change in %	8.7	8.5	-20.6	-17.2	21.4	22.5	4.3	3.6
Imports of services, BOP, EUR m	4,740	5,113	5,436	1,875	3454	6,200	6,100	6,230
annual change in %	12.1	7.9	6.3	-20.6	84.2	14.1	-1.6	2.1
FDI liabilities, EUR m	1,039	2,718	3,055	895	4656	3700	.	.
FDI assets, EUR m	-209	1,629	275	5	3052	600	.	.
Gross reserves of CB excl. gold, EUR m	651	1,256	1,615	1,666	2,035	.	.	.
Gross external debt, EUR m	20,189	21,161	24,452	24,355	26,255	25,500	26,400	27,200
Gross external debt, % of GDP	78.2	76.3	91.1	90.8	87.5	85.0	82.0	80.0

1) Preliminary. - 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.