ESTONIA: Restraining inflation as a test for resilience

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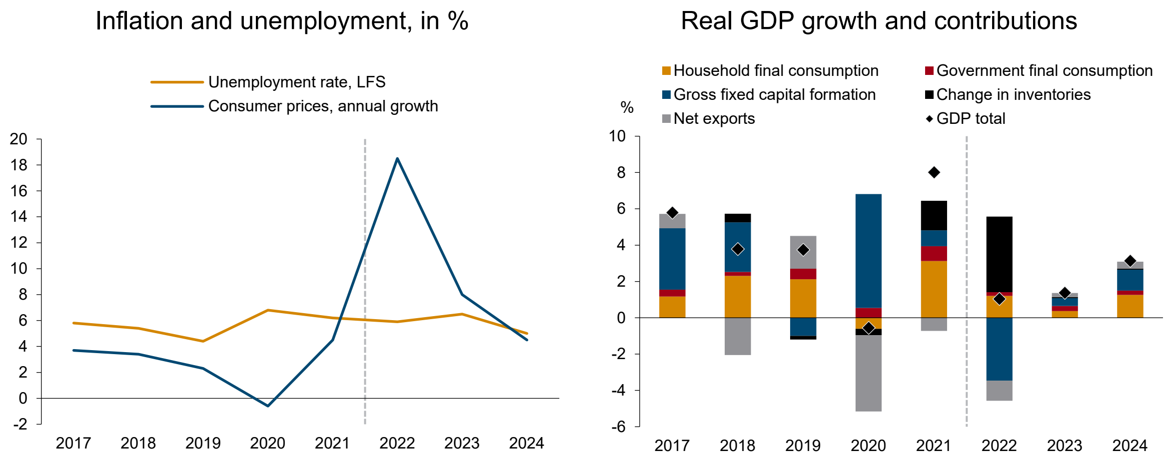
As the economic effects of the war in Ukraine gradually reveal themselves, the Estonian economy is heading for a difficult phase: inflation is extremely high; the foreign trade outlook is getting grimmer; and private consumption is being undermined by rocketing prices and shrinking savings. Yet, we expect the economic decline to be more of a dip, as energy prices are reined in, while purchasing power will be backed by state support and steady wage growth.

Figure 6.7 / Estonia: Main macroeconomic indicators



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

Following a strong economic performance in Q1 2022, the first indications of looming economic decline came in the summer, with GDP growth of 0.6% year on year in Q2 2022 – well below other EU-CEE countries. Good sectoral performance, strong consumption and active foreign trade had reinforced growth up until the summer, despite overall uncertainty and mounting inflation. However, a slowdown in manufacturing and retail trade, as well as deteriorating economic sentiment, foreshadowed a downturn, if not a recession. For the full year, GDP growth is expected to be 1.0% (almost the same as our previous forecast), while the projection for 2023 is cut to 1.3%, followed by 3.2% in 2024. The economic downswing in the second half of 2022 is being driven by high inflation and deteriorating domestic and foreign demand.

Estonia faces the highest inflation in the euro area. Reaching almost 25% year on year in August, half of this figure is accounted for by the rise in the cost of energy, which was almost 90% more than last August. Despite rising food prices being responsible for a large chunk of inflation, the price spike in this commodity group was below that seen in the other Baltic states, thanks to increased competition on the local market, with the market newcomer Lidl proving a game-changer. Taking 2022 as a whole, we forecast inflation to average 18.5%, as the overall economic decline will take some of the edge off inflation growth by the end of the year. With the European Central Bank tightening its monetary policy and with the imposition of domestic restrictions on energy prices, we project inflation to decline to 7.5% in 2023 and 4.5% in 2024.

Industrial output remained high in the first half of 2022, with capacity utilisation staying strong and the dreaded supply difficulties proving smaller than expected. However, producer sentiment dropped abruptly in August, driven by mounting uncertainty over future developments in Europe as a whole. With stratospheric energy prices and severe wage pressures, companies keep raising their prices, although this comes at the expense of export competitiveness (especially in the Nordic markets, where energy prices are notably lower) and domestic demand (as the price differential between imported and domestically produced goods narrows). Hence it will become increasingly difficult to pass on to consumers the higher prices paid for production inputs. As the effects of the sanctions on Russia unfold, supply issues may intensify, as imports from Russia – still ongoing in the first half of 2022 – gradually dry up. This will lead to further supply difficulties for producers and will be reflected in nominal production levels.

Foreign trade was in relatively good shape in Q2 2022, driven largely by a strong performance in services. As inflation increased rapidly, exports grew by around 5% in constant prices, with a major chunk of the growth coming from service exports (inflation-adjusted 17% quarter-on-quarter growth in Q2 2022), while imports fell by 0.2% in Q2 2022. We expect the current account deficit to persist at around 0.7% of GDP in 2022, fuelled primarily by exports lagging behind imports, even in those sectors that previously engaged in major export activity. As of early autumn 2022, export orders are already down, reflecting the weakening competitiveness of Estonian producers on foreign markets in light of the severe inflation.

There were no surprises in sectoral dynamics in the first half of 2022. These reflected long-standing trends, with the ICT and business services sectors growing steadily, despite a marked drop in foreign investments. After almost two years in recession, the tourism and hospitality sectors recovered in summer 2022 to make a major contribution to service exports in Q2 2022.

The high level of purchasing power, driven by steadily rising incomes, low unemployment and a liberalisation of the pension system, has been another pillar of economic growth in Estonia – and remained so in Q1 2022, despite soaring inflation and mounting uncertainty. Private consumption grew by 4.8% year on year in Q2 2022, largely funded by savings and money withdrawn from the second pension pillar. Even though purchasing power will likely be undermined in the coming months, as price rises outstrip wage growth in many sectors and as savings shrink, the outlook is not too bleak. Various state benefits approved under the 2023 budget plan will support purchasing power via generous energy price subsidies for households, an increase in family benefits and additional wage rises of up to 15% (or more for some public-sector jobs). Nonetheless, given that we are unlikely to witness an abrupt drop in inflation in 2023, we anticipate that purchasing power will decline to that of pre-pandemic years (at best) and that private consumption growth will slow to 0.8% in 2023 and 2.7% in 2024.

The labour market remained buoyant in the first half of 2022, as the dreaded spike in unemployment caused by the influx of Ukrainian refugees did not materialise; however, it will likely do so in the coming year. With unemployment standing at 5.8% in Q2 2022 and with around 4% growth year on year in the number of those employed in Q2 2022, the labour market coped reasonably well with the initial shock caused by the war in Ukraine. Despite the severe labour shortages (particularly in trade, construction, manufacturing and education), increased uncertainty over future foreign demand and domestic consumption serves to undermine the outlook for employment. Unemployment is expected to stay at 5.9% in 2022. This will be followed by a rise to 6.5% in 2023, as more and more Ukrainian refugees look for a job and as the anticipated overall economic downturn in the second half of 2022 leads to a decline in employment. However, those two effects are likely to be short-lived, and unemployment will decline to 5.0% in 2024.

The steadily upward trend in wages also indicates a strong labour market, yet it is unlikely to be enough for earnings to keep pace with inflation in the second half of 2022. Wage growth reached 10.1% year on year in Q2, largely driven by those sectors with the most desperate need for workers and by a 12% hike in the minimum wage. Wages are likely to keep growing in the second half of 2022 and especially in 2023 in nominal terms, fuelled by the planned wage rises for public-sector workers; however, the real growth will be around 1.4% in 2022, 2.2% in 2023 and 3.8% in 2024.

The state budget will run at a deficit for the foreseeable future, yet on a less dramatic scale than one would anticipate in the current circumstances. High inflation and a strong labour market have netted exceptionally large tax receipts in the year so far. This will enable a bigger chunk of the state support for households and small businesses planned under the 2023 budget to be covered. However, as tax revenues dwindle – due both to a fall in the inflation rate and a rise in the tax-free income threshold in 2023 – the state budget will likely run a deficit of around 4% in coming years.

For a country with an established reputation of having almost zero debt, the relaxation of fiscal policy indicates a paradigm shift – one that has already generated heated political debate. As any major investment in state defence and security, which will be as high as EUR 1bn in 2023, is likely to be funded through loans, an increase in gross government debt is inevitable. Yet, leading political and economic thinkers are calling for a cautious fiscal policy and for the avoidance of further debt accumulation. Those advocating sufficient fiscal space to allow the state to borrow will likely remain in a minority for as long as the current economic crisis lasts.

Table 6.7 / Estonia: Selected economic indicators

	2019	2020	2021 1)	2021	2022	2022	2023	2024
				January-June			Forecast	
Population, th pers., average	1,327	1,330	1,331	.	.	1,380	1,375	1,372
Gross domestic product, EUR m, nom.	27,765	27,465	31,445	14,383	17,084	37,600	41,200	44,400
annual change in % (real)	3.7	-0.6	8.0	8.2	2.4	1.0	1.4	3.1
GDP/capita (EUR at PPP)	24,560	24,580	27,560	.	.	.	.	.
Consumption of households, EUR m, nom.	13,451	13,171	14,618	6,751	8,274	.	.	.
annual change in % (real)	4.4	-1.2	6.5	5.3	6.9	2.6	0.8	2.7
Gross fixed capital form., EUR m, nom.	7,056	8,563	9,076	4,676	3,970	.	.	.
annual change in % (real)	-3.7	24.7	2.8	58.0	-27.0	-12.0	1.5	4.0
Gross industrial production								
annual change in % (real)	6.9	-3.0	7.2	7.5	4.0	4.3	3.0	5.3
Gross agricultural production								
annual change in % (real)	22.8	0.0	-6.7	.	.	.	.	.
Construction industry								
annual change in % (real)	5.8	-6.1	9.4	6.1	4.7	.	.	.
Employed persons, LFS, th, average 2)	671.3	656.6	654.2	645.6	676.8	680	710	720
annual change in %	1.0	-2.2	-0.5	-1.7	4.8	4.0	4.5	1.0
Unemployed persons, LFS, th, average 2)	31.3	47.9	43.1	48.1	40.7	43	49	38
Unemployment rate, LFS, in %, average 2)	4.4	6.8	6.2	7.0	5.7	5.9	6.5	5.0
Reg. unemployment rate, in %, eop 3)	5.3	8.3	6.8	7.6	7.1	.	.	.
Average monthly gross wages, EUR	1,407	1,448	1,548	1,506	1,643	1,860	2,050	2,220
annual change in % (real, gross)	5.0	3.4	2.1	4.2	-6.4	1.4	2.2	3.8
Average monthly net wages, EUR	1,150	1,185	1,266	1,232	1,338	1,520	1,680	1,820
annual change in % (real, net)	5.1	3.5	2.0	4.2	-6.8	1.4	2.3	3.9
Consumer prices (HICP), % p.a.	2.3	-0.6	4.5	1.7	16.5	18.5	8.0	4.5
Producer prices in industry, % p.a.	-0.6	-3.5	17.2	8.3	40.0	20.0	8.5	5.0
General governm. budget, EU def., % of GDP								
Revenues	39.5	39.4	39.0	.	.	45.3	42.0	42.0
Expenditures	39.4	44.8	41.3	.	.	48.8	46.2	45.9
Net lending (+) / net borrowing (-)	0.1	-5.5	-2.3	.	.	-3.5	-4.2	-3.9
General gov. gross debt, EU def., % of GDP	8.5	18.6	17.6	.	.	19.5	21.5	20.7
Stock of loans of non-fin. private sector, % p.a.	3.3	4.8	7.5	5.5	10.6	.	.	.
Non-performing loans (NPL), in %, eop	0.5	0.4	0.2	0.4	0.2	.	.	.
Central bank policy rate, % p.a., eop 4)	0.00	0.00	0.00	0.00	0.00	.	.	.
Current account, EUR m	658	-272	-568	-1,038	91	-260	30	120
Current account, % of GDP	2.4	-1.0	-1.8	-7.2	0.5	-0.7	0.1	0.3
Exports of goods, BOP, EUR m	13,317	13,290	16,367	7,484	9,792	16,450	16,950	17,400
annual change in %	5.8	-0.2	23.2	20.9	30.8	0.5	3.0	2.7
Imports of goods, BOP, EUR m	14,245	13,533	17,662	8,150	11,021	18,900	19,500	20,220
annual change in %	3.1	-5.0	30.5	29.6	35.2	7.0	3.2	3.7
Exports of services, BOP, EUR m	7,197	5,736	8,254	3,522	4,637.0	8,950	9,450	10,150
annual change in %	7.7	-20.3	43.9	28.3	31.6	8.4	5.6	7.4
Imports of services, BOP, EUR m	5,154	5,470	7,073	3,670	3,514	6,800	6,900	7,150
annual change in %	8.6	6.1	29.3	94.5	-4.3	-3.9	1.5	3.6
FDI liabilities, EUR m	2,708	3,122	6,169	4,699	-1,865	1,400	.	.
FDI assets, EUR m	1,634	253	5,558	3,118	-612	860	.	.
Gross reserves of CB excl. gold, EUR m	1,256	1,615	2,081	2,035	2,237	.	.	.
Gross external debt, EUR m	21,135	24,382	26,630	26,285	29,781	34,400	39,300	41,700
Gross external debt, % of GDP	76.1	88.8	84.7	83.6	79.2	91.5	95.5	94.0

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.