

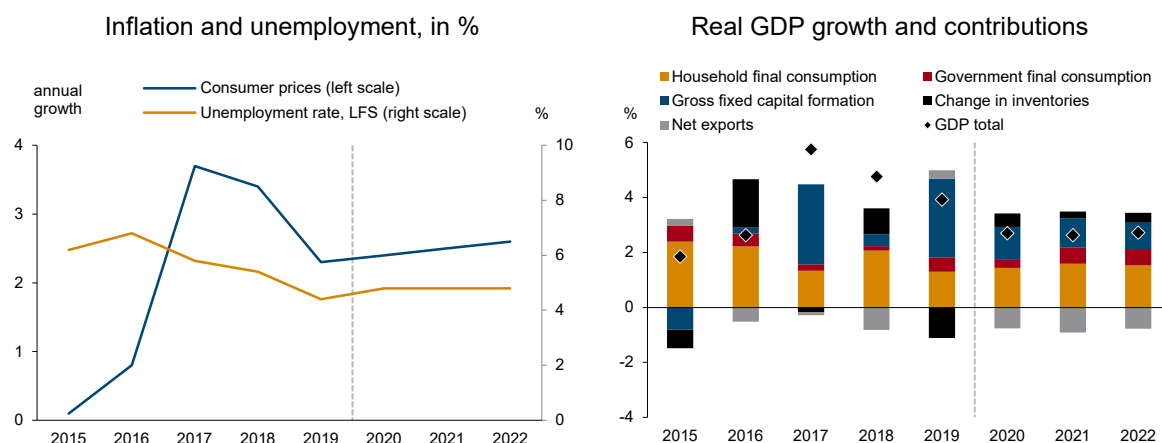


ESTONIA: Slowdown in external demand accompanied by deferred investment activity

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Investment activity is expected to slow in 2020, following last year's strong increase. Furthermore, growth in external demand will continue to decline both this year and in 2021. Household consumption, backed by an ongoing rise in employment and real wages, continues to be a strong driver of economic activity. We project a decline in GDP growth to 2.7% in 2020, followed by a further slowdown to 2.5% in 2021 and a slight upswing to 2.7% in 2022.

Figure 6.7 / Estonia: Main macroeconomic indicators



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

Following a year in which GDP growth was still above expectations (3.9% in real terms year on year), 2020 will see a cooling of economic activity. In the first half of 2019, goods exports were still expanding strongly; only later did the marked slowdown set in. A relatively low price for crude oil (below USD 60 a barrel on average) resulted in a fall in foreign demand for Estonian shale oil (which is used as a substitute for petroleum) of more than 20% in nominal terms in 2019, compared to 2018. Estonian producers of electronic products suffered from ailing demand from Swedish firms. However, the Estonian ICT sector, which accounts for a growing share of total value added in the economy, reported continued growth rates in services exports.

In the years 2020-2021, we expect real growth in goods exports to decline further. Aside from low external demand from non-EU destinations, exports to Sweden are also sluggish due to the weak developments on the housing market there. This is having a negative impact on the manufacturing and service exports of the Estonian building sector. Slower growth in Russia already led to stagnation in Estonian exports to its neighbour last year, and this will continue in 2020. Given the swiftly rising household incomes, imports are expected to increase as strongly as exports. In general, extensive wage increases – and thus higher unit labour costs – are putting pressure on the competitiveness of the

industrial sector in Estonia. A slight increase in external demand is expected to occur only in 2022, based on the assumption that the Northern European countries will see an upswing in trade volumes in line with the advanced economies in general.

After a surge in 2019, growth in investment activity will decline substantially this year. The 2020 government budget foresees some reduction in the ratio of public investments to GDP. However, construction of the main infrastructure of Rail Baltica – the high-speed train project connecting the Baltic states with the Central European network – should lead to a revival in 2021-2022. With the sentiments of entrepreneurs – particularly in industry and construction, but also in some service sectors – turning rather negative in recent months, we also expect growth in private investment to decline this year. A strong growth in wages and the negative real interest rates experienced for a while now are driving a continued increase in new mortgages for households (+6.4% in 2019 year on year). Real estate prices are still growing. Following an increase in the number of building permits issued for dwellings in 2019, we expect an upswing in housing construction in 2020.

Throughout 2019, the unemployment rate continued to decline and is expected to average 4.4% for the year as a whole (according to LFS). A further fall will not, however, occur in the near future. Job vacancy rates did not increase further in 2019 compared to the previous year and fell markedly in industry due to declining expectations for production and exports. Given the expected growth slowdown, the labour market situation is likely to remain unchanged in the coming two years, with a slight increase in unemployment due to restructuring. However, employment will rise further in the public sector, as well as in most other service sectors. Thus, we expect a further gradual increase in jobs.

Given the still rather tight labour market situation, wages will continue to rise substantially in 2020. Real gross wages picked up by another 4% year on year in 2019; however, last year employees started to save more of their wages. In 2020, household incomes will be bolstered by an 8% rise in the minimum wage (to EUR 584) in January 2020. Since 2017, the social partners have sought to raise the minimum wage by twice the forecast rate of labour productivity for the respective year. This path will result in the minimum wage reaching 40% of the average wage in 2021. Following a decrease to 2.3% last year, consumer price inflation is likely to decline again in 2020, mostly on account of falling prices for energy (particularly imported electricity from the country's northern neighbours) and lower excise duty hikes. This will also result in a further strengthened real income growth. Forward-looking consumer confidence indicators and the sentiments of retail entrepreneurs suggest that household consumption will remain stable and will continue as a driver of growth in the next two years.

On the basis of the approved budget of the government for 2020, we expect the deficit to decline to 0.2% of GDP, with a structural deficit of no more than 0.7% of GDP. No changes in taxes are envisaged for 2020, except that there will be an increase in the non-taxable minimum income and a smaller than expected rise in excise duties. Thus, the tax burden of 33.2% of GDP will remain stable and is even likely to decline in 2022. Above-average growth in spending is planned particularly for health and social protection. The public debt level is likely to decrease to below 8% of GDP as early as 2020. The pension hike of EUR 45 per month, introduced in January 2020, has boosted the average pension by about 10% in nominal terms.

Details of the reform of the Estonian pension system – due to be implemented in January 2021 – are still pending. However, the plan envisages transformation of the funded second pillar from a mandatory to a voluntary system. While some commend the change for bringing greater competition to the financial markets, others point out that the reduction in the mandatory pension contributions of employers and employees is likely to increase old-age poverty in the future. Apart from greater volatility in effective retirement pay, the short-term effects of the reform are unclear. Since employees can opt out of the second pillar from 2021 onwards, there may be a small positive growth effect, if individuals use those assets for private investment or consumption purposes in 2021-2022.

Since our 2019 Autumn Forecast, we have become slightly more optimistic, increasing the forecast GDP growth rate for 2020 from 2.6% to 2.7% on the back of ongoing stable household investment and consumption activity. The relatively tight situation on the labour market will keep wage growth high and will thus also bolster private consumption over the next two years. While investment growth was high in 2019, a slower pace of public expenditure and a reluctance on the part of business to spend money on machines and equipment will result in anaemic overall investment growth in 2020. Although external demand activity will decline further in the next two years, over the longer term we expect export growth to increase again in 2022. Consequently, we forecast a decline in GDP growth rates to 2.5% for 2021, but a minor rally to 2.7% in 2022.

Table 6.7 / Estonia: Selected economic indicators

	2015	2016	2017	2018	2019 ¹⁾	2020	2021	2022
						Forecast		
Population, th pers., average	1,315	1,316	1,317	1,322	1,328	1,335	1,340	1,342
Gross domestic product, EUR mn, nom.	20,782	21,694	23,776	26,036	27,700	29,100	30,600	32,200
annual change in % (real)	1.8	2.6	5.7	4.8	3.9	2.7	2.6	2.7
GDP/capita (EUR at PPP)	22,100	22,300	23,600	25,300	26,500	.	.	.
Consumption of households, EUR mn, nom.	10,329	10,869	11,566	12,502	13,100	.	.	.
annual change in % (real)	4.9	4.5	2.7	4.2	2.7	3.0	3.3	3.2
Gross fixed capital form., EUR mn, nom.	5,054	5,054	5,899	6,211	7,100	.	.	.
annual change in % (real)	-3.2	0.9	12.5	1.7	12.0	5.0	4.5	4.0
Gross industrial production								
annual change in % (real)	0.3	3.4	4.1	4.0	-2.1	1.5	2.0	3.0
Gross agricultural production								
annual change in % (real)	8.7	-17.2	6.5	-6.3	20.6	.	.	.
Construction industry								
annual change in % (real)	-3.5	4.6	21.5	17.4	1.0	.	.	.
Employed persons, LFS, th, average	640.9	644.6	658.6	664.7	671.3	677	680	685
annual change in %	2.6	0.6	2.2	0.9	1.0	0.8	0.4	0.7
Unemployed persons, LFS, th, average	42.3	46.7	40.3	37.7	31.3	34	34	35
Unemployment rate, LFS, in %, average	6.2	6.8	5.8	5.4	4.4	4.8	4.8	4.8
Reg. unemployment rate, in %, eop ²⁾	4.7	4.4	4.8	4.8	4.8	.	.	.
Average monthly gross wages, EUR	1,065	1,146	1,221	1,310	1,390	1,470	1,560	1,650
annual change in % (real, gross)	6.5	7.4	3.5	3.5	4.0	3.6	3.4	3.4
Average monthly net wages, EUR	859	924	985	1,050	1,120	1,180	1,240	1,310
annual change in % (real, net)	8.0	7.4	3.0	3.2	4.2	3.3	2.7	3.0
Consumer prices (HICP), % p.a.	0.1	0.8	3.7	3.4	2.3	2.4	2.5	2.6
Producer prices in industry, % p.a.	-2.5	-0.9	3.3	3.9	-0.6	0.0	2.0	3.0
General governm. budget, EU-def., % of GDP								
Revenues	39.4	39.0	38.6	38.5	39.3	39.0	39.0	38.8
Expenditures	39.2	39.5	39.3	39.1	39.6	39.2	39.2	40.8
Net lending (+) / net borrowing (-)	0.1	-0.5	-0.8	-0.6	-0.3	-0.2	-0.2	-0.2
General gov.gross debt, EU def., % of GDP	10.0	10.2	9.3	8.4	8.3	8.0	7.8	7.6
Stock of loans of non-fin.private sector, % p.a.	4.8	6.6	0.7	5.1	3.7	.	.	.
Non-performing loans (NPL), in %, eop	1.1	1.0	0.8	0.5	0.5	.	.	.
Central bank policy rate, % p.a., eop ³⁾	0.05	0.00	0.00	0.00	0.00	.	.	.
Current account, EUR mn	366	360	635	516	471	310	710	560
Current account, % of GDP	1.8	1.7	2.7	2.0	1.7	1.1	2.3	1.7
Exports of goods, BOP, EUR mn	10,692	11,293	12,029	12,720	13,336	13,500	14,550	15,250
annual change in %	-3.0	5.6	6.5	5.7	4.8	1.2	7.8	4.8
Imports of goods, BOP, EUR mn	11,571	12,043	12,866	13,720	14,227	14,800	15,500	16,450
annual change in %	-3.7	4.1	6.8	6.6	3.7	4.0	4.7	6.1
Exports of services, BOP, EUR mn	5,284	5,509	6,074	6,613	6,936	7,200	7,500	7,900
annual change in %	-1.9	4.3	10.2	8.9	4.9	3.8	4.2	5.3
Imports of services, BOP, EUR mn	3,593	3,911	4,219	4,699	4,946	5,150	5,400	5,700
annual change in %	-2.7	8.9	7.9	11.4	5.3	4.1	4.9	5.6
FDI liabilities, EUR mn	-654	832	1,532	996	2,782	1300	.	.
FDI assets, EUR mn	-522	315	606	-221	1,676	300	.	.
Gross reserves of NB excl. gold, EUR mn	373	325	279	651	1,259	.	.	.
Gross external debt, EUR mn	19,161	19,194	19,766	19,886	21,900	22,700	23,900	25,800
Gross external debt, % of GDP	92.2	88.5	83.1	76.4	79.0	78.0	78.0	80.0

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.