ESTONIA: Tight labour market without overheating

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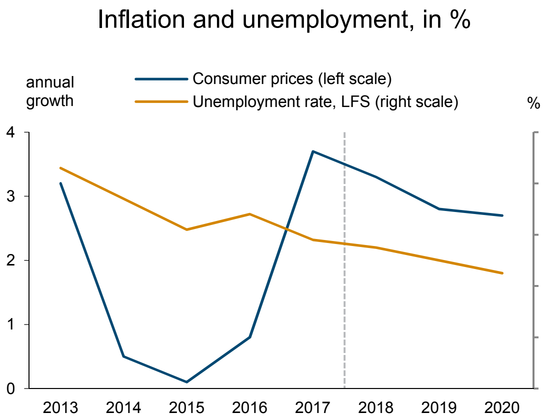
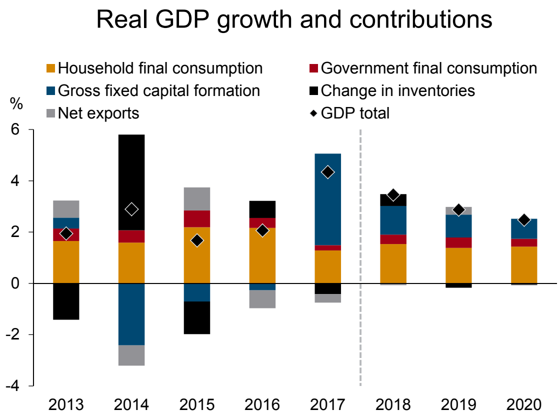
Investment activity has abated so far in 2018, following last year's peak growth induced by fresh inflows of EU funds. However, external demand continued growing at a higher pace than expected. Household consumption, backed by a considerable rise in employment and real wages, continues to be a strong driver of economic activity. We project GDP to grow at a rate of 3.5% in 2018 and 3.1% in 2019, while declining somewhat to 2.7% in 2020.

Figure 42 / Estonia: Main macroeconomic indicators





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

Export growth was quite strong in 2018, particularly towards other EU countries. Goods exports to Russia, which increased by more than 20% nominally in 2017, however, will decline somewhat in 2018. The Estonian wood manufacturing sector has benefited in recent years from stable growth of construction in Sweden. The cooling off in the housing sector there, and the forecast price and investment decline in the Swedish housing sector, has resulted in deteriorating prospects for Estonian entrepreneurs. In general, strongly rising wages in Estonia are putting pressure on exporting firms, but moving up the value chain will require increased investment activity in manufacturing. At the moment, however, trade in electrical appliances and other higher-value goods is rather anaemic. The actual driver of nominal export growth in 2018 so far has been the rising oil price. This has supported demand for Estonian shale oil – exports are likely to increase by 30-40% in real terms this year compared to 2017. Overall, we expect real growth in goods exports to level off in 2019-2020. Given swiftly rising household incomes, imports will increase more strongly than exports. At the same time, the exports of services are growing much more strongly than those of goods. As well as the transport and tourism sector, ICT and business services are strongly export oriented and flourishing.

After a slowdown in 2018, growth in investment activity is expected to become stronger in 2019-2020. In 2017, the first inflows of EU funds from the 2014-2020 programming period resulted in high growth rates. Public investment has increased at a lower rate in 2018, but in 2019, and particularly 2020, the construction of the main terminals of Rail Baltica, the high-speed train project connecting the Baltics with the Central European network, will result in a revival of investment. Given the favourable demand situation, private enterprises are increasing their investments in equipment and buildings, thus construction activity is prospering as well. Strong growth in wages and very low interest rates are driving an ongoing increase in new credits to households. Real estate prices are currently growing rapidly, and are above pre-crisis levels in Tallinn. Given the low-interest rate environment, housing construction may remain strong for a while; however the number of building permits granted shows that a levelling off is likely towards 2020.

Throughout the year, the unemployment rate fell considerably and is expected to average 5.5% (according to LFS) for 2018 as a whole. Given the favourable economic developments, a further gradual decline will take place. A longer term view on the development of the work force shows that a decline of about 5% is likely in the next 10 years. The employment rate will thus rise further, which at 79% (among 15-64 year-olds as of Q2/2018) is already at the level of the Scandinavian countries (which are the highest in the EU). In the 65-74 age group, 29% of the population is still working, which is much more than anywhere else in the EU and in this respect only comparable to Iceland (41%). This increases the labour supply to some extent and raises the unemployment rate temporarily, while the inactivity rate declines. Employment figures show the relatively swift restructuring of the Estonian economy towards services. In the past 10 years the number of jobs in the ICT sector doubled (4.7% of total employment) and increased much more than the EU average (3.1%). Employment growth is also strong in other high value service sectors.

Given the tight labour market situation, wages will continue to rise strongly in the next few years. Real gross wages picked up by another 3.7% year on year in the first half of 2018, and as a result consumer demand remains strong. Household incomes will be bolstered by a further 8% increase in the minimum wage from January 2019 onwards to EUR 540 per month, and a reduction in personal income tax. Also, after a 3.7% peak recorded last year (mostly caused by an increase in excise taxes and by rising energy prices), consumer price inflation started to decline slightly in 2018 which has further strengthened real income growth. Forward-looking consumer confidence indicators are positive and the most recent retail trade and credit statistics indicate positive sentiment among consumers.

The draft budget of the Estonian centrist coalition government for 2019 foresees a continuation of the fiscal surplus path, without further tax changes planned for 2020. Above average expenditure growth is planned for defence and the health and welfare sectors, including an increase in child benefits. Subsidies will be raised for public transport in order to increase the use of free buses. After having been introduced in the capital city of Tallinn in 2013, 11 of 15 counties followed in July 2018. The scheme is expected to reduce emissions slightly, but more particularly, to lower transport costs for less well-off residents. The fiscal strategy of the Estonian government is to bring public debt down to 5% of GDP over the coming three years.

We have not altered our positive outlook for the Estonian economy compared to our previous forecast; real GDP is expected to grow by 3.5% this year. 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 of GDP growth rates to 3.1% and 2.7% for 2019 and 2020 respectively.

Table 17 / Estonia: Selected economic indicators

	2014	2015	2016	2017 1)	2017 January-June	2018 January-June	2018 Forecast	2019 Forecast	2020 Forecast
Population, th pers., average	1,315	1,315	1,316	1,315	.	.	1,318	1,320	1,322
Gross domestic product, EUR mn, nom.	20,061	20,652	21,683	23,615	11,368	12,259	25,200	26,700	28,200
annual change in % (real)	2.9	1.9	3.5	4.9	5.4	3.5	3.5	3.1	2.7
GDP/capita (EUR at PPP)	21,300	22,000	22,500	23,700	.	.	.	.	.
Consumption of households, EUR mn, nom.	9,835	10,243	10,777	11,448	5,617	6,016	.	.	.
annual change in % (real)	3.0	4.3	4.3	2.5	1.3	3.9	3.5	3.2	3.1
Gross fixed capital form., EUR mn, nom.	5,139	4,872	4,978	5,770	2,813	2,748	.	.	.
annual change in % (real)	-2.6	-7.6	2.9	12.5	17.3	-4.7	3.0	5.4	6.0
Gross industrial production									
annual change in % (real)	3.9	0.3	3.4	7.7	11.8	4.4	5.0	4.5	4.5
Gross agricultural production									
annual change in % (real)	4.6	8.7	-17.2	9.5	.	.	.	.	.
Construction industry									
annual change in % (real)	-2.1	-3.5	4.6	17.7	18.8	20.5	.	.	.
Employed persons, LFS, th, average	624.8	640.9	644.6	658.6	650.2	658.6	665	670	670
annual change in %	0.6	2.6	0.6	2.2	1.0	1.3	1.0	0.8	0.0
Unemployed persons, LFS, th, average	49.6	42.3	46.7	40.3	43.7	41.6	39	35	32
Unemployment rate, LFS, in %, average	7.4	6.2	6.8	5.8	6.3	6.0	5.5	5.0	4.5
Reg. unemployment rate, in %, eop 2)	4.4	4.7	4.4	4.8	4.5	4.5	.	.	.
Average monthly gross wages, EUR	1,005	1,065	1,146	1,226	1,198	1,282	1,300	1,380	1,470
annual change in % (real, gross)	6.0	6.5	7.4	3.5	3.1	3.7	3.0	3.3	3.5
Average monthly net wages, EUR	799	859	924	985	.	.	1,050	1,120	1,190
annual change in % (real, net)	5.7	8.0	7.4	3.0	.	.	3.0	3.3	3.5
Consumer prices (HICP), % p.a.	0.5	0.1	0.8	3.7	3.2	3.3	3.3	2.8	2.7
Producer prices in industry, % p.a.	-2.1	-2.5	-0.9	3.3	3.0	3.6	3.0	2.5	2.3
General governm. budget, EU-def., % of GDP									
Revenues	38.5	39.7	39.2	38.9	.	.	38.6	38.6	38.6
Expenditures	37.9	39.6	39.5	39.2	.	.	39.0	38.8	38.8
Net lending (+) / net borrowing (-)	0.7	0.1	-0.3	-0.3	.	.	-0.4	-0.2	-0.2
General gov.gross debt, EU def., % of GDP	10.5	9.9	9.2	8.7	.	.	8.5	8.0	8.0
Stock of loans of non-fin.private sector, % p.a.	2.6	4.8	6.6	0.7	5.7	1.1	.	.	.
Non-performing loans (NPL), in %, eop	1.5	1.1	1.0	0.8	0.8	0.7	.	.	.
Central bank policy rate, % p.a., eop 3)	0.05	0.05	0.00	0.00	0.00	0.00	.	.	.
Current account, EUR mn	162	381	425	751	236	38	246	46	-204
Current account, % of GDP	0.8	1.8	2.0	3.2	2.1	0.3	1.0	0.2	-0.7
Exports of goods, BOP, EUR mn	11,026	10,689	11,294	12,022	5,903	6,140	12,600	13,200	13,750
annual change in %	0.5	-3.1	5.7	6.4	5.6	4.0	4.8	4.8	4.2
Imports of goods, BOP, EUR mn	12,019	11,571	12,055	12,839	6,333	6,796	13,700	14,600	15,500
annual change in %	1.1	-3.7	4.2	6.5	5.9	7.3	6.7	6.6	6.2
Exports of services, BOP, EUR mn	5,385	5,284	5,532	6,054	2,870	3,093	6,500	6,950	7,400
annual change in %	7.9	-1.9	4.7	9.4	11.6	7.8	7.4	6.9	6.5
Imports of services, BOP, EUR mn	3,678	3,575	3,888	4,162	2,001	2,185	4,500	4,850	5,200
annual change in %	4.1	-2.8	8.8	7.0	6.9	9.2	8.1	7.8	7.2
FDI liabilities, EUR mn	1,331	-654	845	1,403	957	833	1403	.	.
FDI assets, EUR mn	847	-521	341	543	778	141	300	.	.
Gross reserves of NB excl. gold, EUR mn	352	373	325	279	282	325	.	.	.
Gross external debt, EUR mn	19,040	19,163	19,162	19,512	19,548	19,848	20,200	21,400	22,600
Gross external debt, % of GDP	94.9	92.8	88.4	82.6	82.8	78.8	80.0	80.0	80.0

1) Preliminary. - 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.