6. ESTONIA

Growth slips this year but should pick up with external demand

Real GDP growth in Estonia is expected to slip to 1.1% this year but should recover to 2.3% in 2017 and 2.6% in 2018, as negative external shocks fade and investment recovers. Unemployment is set to rise as reforms prompt work-incapacity pensioners to re-enter the labour market. The fiscal position is projected to dip below balance in 2017-2018 but public debt should remain below 10% of GDP.

Growth in 2016 has been disappointing

After dropping to 1.4% in 2015, annual real GDP growth in Estonia slowed further in the first half of 2016, as imports grew significantly faster than exports. This mainly reflected higher imports of capital goods, demanded by the resumption of investment. However, exports began to grow again even though the country's oil shale sector and related-exports continued to suffer from low international energy prices. Private consumption slightly decelerated, amid rising inflation, despite robust hourly wage growth in a tight labour market. In parallel, public consumption stabilised, allowing public finances to remain strong. Overall, real GDP growth is expected at 1.1% in 2016.

Net exports are set to improve, albeit slowly

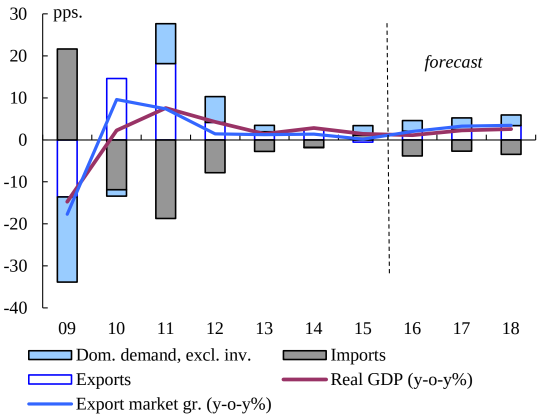
Estonia's real GDP is forecast to grow by 2.3% in 2017 and 2.6% in 2018 as external demand, especially from Finland and the other two Baltic States, gathers pace and international oil prices rise. Growth in exports and imports turned positive in early 2016. However, as import-intensive investment resumes and competitiveness gains remain limited, the contribution of net exports to growth will likely remain negative over the forecast period. In services, high tech exports increasingly offset contracting exports in transport, as transit trade with Russia collapsed. The external balance of goods and services is set to remain positive over the forecast period.

Investment resumes

Industry confidence is improving with the rise in regional demand. Also, companies are increasingly investing in equipment as the domestic labour force is becoming more expensive. Estonian businesses are therefore projected to increase investment over the forecast horizon. This is expected to be accompanied by higher bank lending to enterprises. In parallel, public investment is projected to soar in 2017 as the bulk of projects under the new programming period of EU investment enter the implementation phase.

By contrast, private consumption growth is expected to decelerate in 2017 and 2018 as rising consumer price inflation overshadows the increase in wages. Similarly, household investment is set to slow due to lower real incomes. Nevertheless, domestic demand is set to remain the main driver of growth over the forecast horizon.

Graph II.6.1: **Estonia - Real GDP growth and contributions, export market growth**



Risks to the forecast are balanced. Positive risks relate to the possibility of an earlier-than-expected recovery of neighbouring economies, especially Finland, and to higher-than-assumed oil prices. On the downside, lower demand from other EU Member States could further delay a rebound in growth.

The work ability reform affects the labour market

The working age population has declined significantly over the past years due to ageing and emigration, but higher wages have raised the participation rate to historically high levels of 70%. Recently, also emigration flows have reversed. Considering the already high participation rate and lacklustre GDP growth, the room for further employment gains appears limited. Nevertheless, the introduction of a 'work ability' reform in mid-2016 is gradually bringing work-incapacity pensioners back to the labour market. Owing to the reform, employment is expected to continue growing in 2017-2018, while unemployment is also projected to rise from about 6½ % in 2016 to over 8% in 2018. Wage growth is forecast to remain robust, albeit slowing to about 5% annually in 2017-2018 on account of public sector wage restraint.

Inflation is on the rise

HICP inflation has been increasing since mid-2016, driven by food prices and the fading base effect from low energy prices. Inflation is projected to accelerate to around 2.7% in 2017-18. The increase is driven by an assumed rise in global energy prices, strong wage growth, and a significant rise in excise tax rates. These, together with some administrative price rises, are set to push inflation up by almost 1 pp. in 2017 and 0.5 pps. in 2018.

Strong fiscal outcome despite weak GDP growth

While GDP growth remains moderate, its composition appears favourable to government revenue, especially labour and consumption taxes. As a result, after a surplus of 0.1% of GDP in 2015, 2016 is set to close with a general government surplus of 0.5% of GDP. An important contributor to the surplus is lower-than-planned expenditure on investment. In 2017, by contrast, public investment is forecast to rebound as the bulk of EU funded projects from the new programming period take off. In parallel, local elections, taking place in 2017, typically lead to higher investment. Higher social expenditure and costs related to the EU Council Presidency in the second half of 2017 are also projected to add to expenditure growth. However, the central government is projected to cut government employment and curb the growth of the public sector wage bill, which should lead to some savings. On the revenue side, a stepwise reduction in labour taxes in 2016-18, is set to be partly financed by rising excise taxes on fuels, tobacco and alcohol. Also, a temporary increase of state transfers to the second-pillar pension fund over 2014-17 will come to an end. Overall, the general government deficit is projected at 0.4% of GDP in 2017 and 0.2% of GDP in 2018. In structural terms, this should lead to a slight deficit in 2017 and a balance in 2018. Estonia's public debt is expected to stand below 10% of GDP in 2016-18.

Table II.6.1:

Main features of country forecast - ESTONIA

	2015		Annual percentage change						
bn EUR	Curr. prices	% GDP	97-12	2013	2014	2015	2016	2017	2018
GDP	20.3	100.0	4.4	1.4	2.8	1.4	**1.1**	**2.3**	**2.6**
Private Consumption	10.6	52.4	4.5	3.8	3.3	4.7	**3.3**	**2.9**	**2.8**
Public Consumption	4.1	20.3	1.9	1.9	2.7	3.4	**0.0**	**1.3**	**0.6**
Gross fixed capital formation	4.8	23.7	7.6	-2.8	-8.1	-3.3	**3.2**	**5.3**	**4.8**
of which: equipment	1.8	8.6	8.7	17.0	-11.6	-12.4	**3.3**	**5.8**	**5.5**
Exports (goods and services)	16.1	79.3	8.3	2.3	3.1	-0.6	**2.7**	**3.3**	**3.5**
Imports (goods and services)	15.2	75.1	8.8	3.2	2.2	-1.4	**4.9**	**4.2**	**4.0**
GNI (GDP deflator)	19.8	97.9	4.1	3.2	2.4	2.1	**0.6**	**2.3**	**2.8**
Contribution to GDP growth: Domestic demand			5.4	1.5	0.0	2.3	**2.5**	**3.0**	**2.8**
Inventories			0.2	0.0	2.5	-1.6	**0.2**	**-0.3**	**0.1**
Net exports			-1.0	-0.8	0.8	0.6	**-1.6**	**-0.5**	**-0.2**
Employment			-0.3	1.2	0.8	2.9	**1.2**	**0.2**	**0.2**
Unemployment rate (a)			10.4	8.6	7.4	6.2	**6.5**	**7.4**	**8.3**
Compensation of employees / head			10.2	4.6	4.2	5.7	**6.1**	**5.1**	**5.0**
Unit labour costs whole economy			5.3	4.5	2.2	7.2	**6.2**	**2.9**	**2.5**
Real unit labour cost			-0.5	0.6	0.4	6.1	**2.4**	**-0.1**	**-0.8**
Saving rate of households (b)			4.2	6.3	9.4	6.9	**9.1**	**9.7**	**9.8**
GDP deflator			5.9	3.9	1.7	1.0	**3.7**	**3.0**	**3.3**
Harmonised index of consumer prices			4.8	3.2	0.5	0.1	**0.8**	**2.6**	**2.7**
Terms of trade goods			0.8	0.8	0.0	0.1	**3.4**	**0.1**	**0.2**
Trade balance (goods) (c)			-14.0	-5.2	-5.1	-4.3	**-3.5**	**-3.9**	**-4.2**
Current-account balance (c)			-7.6	-0.2	1.0	2.1	**1.8**	**1.6**	**1.5**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-6.2	2.4	2.1	4.2	**3.2**	**3.1**	**3.0**
General government balance (c)			0.4	-0.2	0.7	0.1	**0.5**	**-0.4**	**-0.2**
Cyclically-adjusted budget balance (d)			-0.3	-0.8	-0.3	-0.4	**0.5**	**-0.2**	**0.0**
Structural budget balance (d)			-	-0.6	-0.1	-0.1	**0.6**	**-0.2**	**0.0**
General government gross debt (c)			5.8	10.2	10.7	10.1	**9.4**	**9.5**	**9.4**

(a) as % of total labour force. (b) gross saving divided by gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.

Note : Contributions to GDP growth may not add up due to statistical discrepancies.