6. ESTONIA

Strong growth underpins catching-up

Positive investment and net exports are set to raise GDP growth from 1.6% in 2016 to 2.3% in 2017 and 2.8% in 2018. Unemployment is on the rise as reforms encourage disability pensioners to re-enter the labour market. Global food and energy prices and a significant increase in excise duties are driving up inflation. The fiscal position is projected to turn into a deficit over the forecast horizon, reflecting the loosening of fiscal policy through increased investment.

Domestic demand as the main growth driver

Improving upon 1.6% growth in 2016, Estonia's real GDP is forecast to grow by 2.3% in 2017 and 2.8% in 2018, as investment and exports growth gain momentum. In particular, domestic demand is projected to grow, as businesses start investing again and EU funds are put to use. Healthy export growth is expected to continue, thanks to higher demand from Estonia's main trading partners. Although slowing down, private consumption growth is set to remain relatively strong, as overall disposable income should keep rising at a fast pace despite inflation. Overall, domestic demand is expected to remain the main growth contributor, although increasingly driven by investment rather than by private consumption.

Recovering investment is set to lift growth

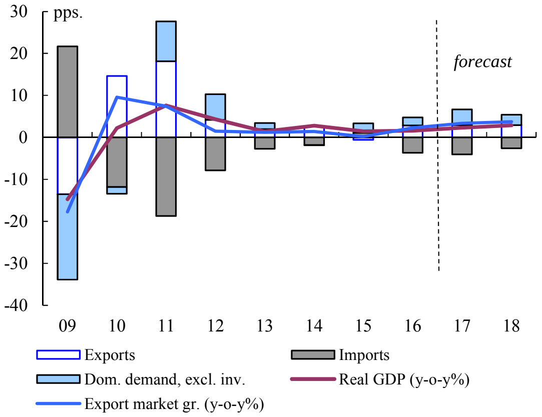
Business confidence has been increasing, supported by the upward global trend of external demand, improving business investment prospects. In particular, the rebound in export prices is expected to support the turnover growth of enterprises, closing the gap between wage growth and productivity growth, restoring profits and thereby investment. In parallel, public investment is forecast to rebound, as the flow of investment projects related to EU funds starts to pick up. Headline investment figures in 2017 are influenced by a large purchase of ferries. The latter is mirrored by imports and, thereby, neutral on Estonia's overall output.

Conversely, although wage growth remains strong, real disposable income growth is expected to slow, particularly in 2017 as a result of tax hikes and rising inflation. This limits private consumption growth. Furthermore, the high private investment growth in construction, which is reflected in the strong growth of credit, is set to slow down over the forecast horizon. Private consumption is expected to pick up again in 2018 with the reduction of the tax wedge for low wage earners.

Strengthening demand in trading partners supports exports

External demand, especially from Sweden, Germany and the other two Baltic States, is expected to strengthen, and demand from Finland and Russia is gradually recovering. Even though price levels are set to remain largely below peak levels, the recent increases in oil prices will support the recovery of Estonia's shale oil sector and its related exports. The services export surplus is expected to remain broadly stable, ensuring that the external balance of goods and services will remain positive over the forecast period.

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



Unemployment and employment both to rise

In spite of a declining working age population, mostly due to negative natural change, labour supply and employment are expected to increase over the forecast horizon. Higher wages and an increase in the effective pension age have already raised the labour market participation rate to a historically high level and this is projected to further increase over the forecast horizon. Labour supply is supported by a turnaround in migration, leading to net immigration (mostly from Estonians returning from abroad) and the introduction of the 'work-ability' reform in mid-2016. As a result, unemployment is projected to increase from about

6.8% in 2016 to about 8.6% in 2018. Wages are projected to continue growing relatively rapidly at over 5% in 2017 and 2018.

Energy, food and excises duties drive inflation

HICP inflation jumped to over 3% in the first months of 2017, driven by global food and energy prices. Also, a significant rise in excise duties on fuels, alcohol, tobacco and sweetened drinks is estimated to raise inflation by almost 1.0 pp. in both 2017 and 2018. Inflation is projected to reach 3.3% in 2017 and to abate to 2.9% in 2018 as global commodity prices stabilise.

An expansionary fiscal stance

The general government recorded a surplus of 0.3% of GDP in 2016. In 2017, public finances are set to turn into a deficit of 0.3% of GDP, driven by expenditure increases, especially by surging public investment, both EU- and domestically-funded. For 2018, the government plans for a further fiscal loosening via an investment programme costing 0.5% of GDP. The government also plans for a multitude of new expenditure programmes in healthcare, education, social funding and in financing local governments, amounting to about 1% of GDP, which should be fully offset by an array of tax increases. The current forecast takes account of all these new fiscal measures, as they are sufficiently detailed in the governments' 2017 stability programme. Overall, the headline fiscal deficit is projected to decline to 0.5% of GDP in 2018. In structural terms, the fiscal deficit is estimated at ⅓% of GDP in 2017 and ¾% in 2018. Public debt is expected to remain under 10% of GDP. Main negative risks to this fiscal projection pertain to the yield estimates of the various new tax measures.

Table 2.1.1:

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	**1.6**	**2.3**	**2.8**
Private Consumption	10.6	52.4	4.5	3.8	3.3	4.7	**4.1**	**2.6**	**3.8**
Public Consumption	4.1	20.3	1.9	1.9	2.7	3.4	**1.0**	**1.8**	**1.9**
Gross fixed capital formation	4.8	23.7	7.6	-2.8	-8.1	-3.3	**-2.8**	**9.3**	**0.1**
of which: equipment	1.8	8.6	8.7	17.0	-11.6	-12.4	**-0.2**	**13.8**	**-7.1**
Exports (goods and services)	16.1	79.3	8.3	2.3	3.1	-0.6	**3.6**	**3.7**	**3.7**
Imports (goods and services)	15.2	75.1	8.8	3.2	2.2	-1.4	**4.9**	**5.4**	**3.5**
GNI (GDP deflator)	19.8	97.9	4.1	3.2	2.4	2.1	**1.7**	**1.9**	**3.0**
Contribution to GDP growth: Domestic demand			5.4	1.5	0.0	2.3	**1.9**	**3.8**	**2.5**
Inventories			0.2	0.0	2.5	-1.6	**0.6**	**-0.6**	**-0.1**
Net exports			-1.0	-0.8	0.8	0.6	**-0.8**	**-1.1**	**0.3**
Employment			-0.3	1.2	0.8	2.9	**0.3**	**0.3**	**0.2**
Unemployment rate (a)			10.4	8.6	7.4	6.2	**6.8**	**7.7**	**8.6**
Compensation of employees / head			10.2	4.6	4.2	5.7	**5.7**	**5.5**	**5.6**
Unit labour costs whole economy			5.3	4.5	2.2	7.2	**4.3**	**3.4**	**2.8**
Real unit labour cost			-0.5	0.6	0.4	6.1	**2.6**	**-0.2**	**-0.5**
Saving rate of households (b)			4.3	6.2	9.4	8.8	**9.4**	**9.9**	**10.6**
GDP deflator			5.9	3.9	1.7	1.0	**1.7**	**3.6**	**3.3**
Harmonised index of consumer prices			4.8	3.2	0.5	0.1	**0.8**	**3.3**	**2.9**
Terms of trade goods			0.8	0.8	0.0	0.1	**1.1**	**0.2**	**0.0**
Trade balance (goods) (c)			-14.0	-5.2	-5.1	-4.3	**-4.3**	**-5.6**	**-5.3**
Current-account balance (c)			-7.5	-0.2	1.0	2.1	**2.0**	**1.1**	**1.2**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-6.0	2.4	2.1	4.2	**2.9**	**3.1**	**3.3**
General government balance (c)			0.4	-0.2	0.7	0.1	**0.3**	**-0.3**	**-0.5**
Cyclically-adjusted budget balance (d)			-0.2	-0.8	-0.2	-0.4	**0.1**	**-0.3**	**-0.7**
Structural budget balance (d)			-	-0.6	-0.1	-0.1	**0.2**	**-0.3**	**-0.7**
General government gross debt (c)			5.8	10.2	10.7	10.1	**9.5**	**9.5**	**9.6**

(a) as % of total labour force. (b) gross saving divided by adjusted 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.