3. ESTONIA

Sectoral restructuring and weak foreign demand slow down growth

Strong private investment and flexible labour supply have supported growth in the first half of 2019. However, growth is set to slow due to cyclical factors and the ongoing restructuring of the energy production sector. The government budget is expected to continue to be in a slight deficit.

Recovering investment is driving growth

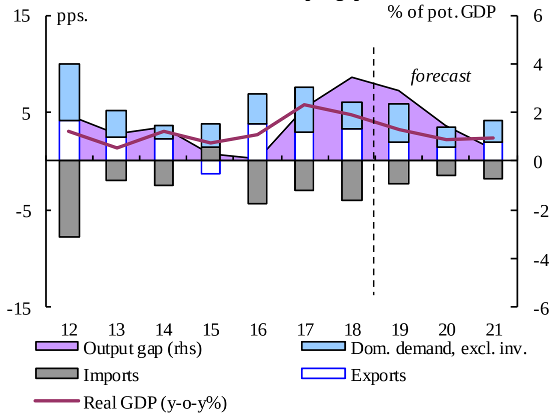
Following strong growth in 2018 of 4.8% and a solid performance in the first half of 2019, economic growth in Estonia is forecast to moderate to 3.2% in 2019. Economic activity in the first half of 2019 was mainly driven by private investment, which rose by over 20% partly reflecting a base effect from low investment a year ago. Investment growth was broad based and particularly strong in machinery and equipment and in residential construction. Investment appears to have been driven by capacity constraints and increased need for automation motivated by labour and skills shortages, as well as by the favourable borrowing conditions and healthy profit margins.

Despite strong investment, industrial output growth is set to decline by the end of the year due to weak external demand. A decline in industrial sector confidence over 2019 signals worsened expectations for the coming quarters. Estonia's oil shale and energy production sectors have been affected by rising CO2 emissions certificate prices. Electricity production is set to decline substantially in 2019 and will contribute negatively to GDP growth.

Private consumption has so far been supported by strong employment growth, as well as by increasing real incomes. At the same time, borrowing by households has remained stable and relatively moderate, with saving rates close to the EU average. Estonia's household debt has marginally declined since 2016 and is projected to stabilise going forward.

In 2020 and 2021, economic growth is expected to slow further in line with cyclical developments. Industrial exports are expected to flatten. Domestic demand is set to remain the key growth driver primarily due to the increase in real disposable incomes supported by moderating inflation. The employment rate and wage increases are forecast to weaken somewhat, but labour market participation is set to remain high. Given the base effect, investment is set to contribute less to growth than in 2019. Corporate profit margins are likely to decrease as foreign demand remains subdued and labour costs elevated. Overall, GDP growth is forecast to slow to 2.1% in 2020 before perking up slightly to 2.4% in 2021, rates that are below the economy's estimated potential growth rate.

Graph II.3.1: **Estonia - Real GDP growth and contributions, output gap**



Price dynamics reflect external factors

HICP inflation is forecast to fall from 3.4% in 2018 to 2.4% in 2019, largely due to lower global energy prices. In addition, consumption tax changes (which were raised sharply prior to 2019) are expected to have a smaller inflationary impact over the forecast horizon. At the same time, prices for services are expected to continue growing rapidly, reflecting the pass-through of high wage growth. Overall, inflation is expected to stay slightly above 2% over 2020 and 2021.

Labour market performs strongly

The cyclical peak in economic activity has led to labour shortages and rapidly rising nominal wages. Short-term capacity constraints of companies have been alleviated through greater labour market flexibility. Since 2017, labour supply has been sustained through inward migration and an increased use of contracted foreign labour, which has helped to address labour needs in the construction and manufacturing sectors.

After a decade of growth, the employment rate is projected to peak at over 79% in 2019 and to stabilise thereafter, in line with slowing economic growth. The rise in the unemployment rate is forecast to be relatively small, given that labour supply is also set to moderate in a setting of population ageing. At the same time, structural skills mismatches are likely to persist, reducing the cost-competitiveness of the Estonian companies.

Public spending growth is set to slow

The general government is projected to run a 0.2% of GDP deficit in 2019. Cyclically strong tax revenues are matched by rapid expenditure growth. Social expenditures (pensions, parental benefits) are growing relatively rapidly due to an indirect link to overall wage growth. At the same time, public sector wage growth has been rapid, also due to hikes in educational and healthcare sector wages. The 2020 state draft budget foresees some expenditure restraint. However, as this coincides with slower economic and revenue growth, the budget is projected to remain in a small nominal deficit of 0.2% in 2020. Under a no-policy-change assumption, the deficit is projected to amount to 0.2% of GDP in 2021.

Given that the economy is forecast to operate well below its potential in 2020 and 2021, the structural fiscal position is projected to improve from a deficit of around 1½% of GDP in 2019 to about 1% of GDP in 2020 and ½% of GDP in 2021. Public debt is forecast to remain low at about 8% of GDP by 2021.

Table II.3.1:

Main features of country forecast - ESTONIA

		2018		Annual percentage change						
		bn EUR Curr. prices	% GDP	00-15	2016	2017	2018	2019	2020	2021
GDP		26.0	100.0	3.8	2.6	5.7	4.8	**3.2**	**2.1**	**2.4**
Private Consumption		12.9	49.7	4.4	4.6	2.8	4.3	**3.4**	**3.0**	**2.6**
Public Consumption		5.1	19.6	2.2	2.4	1.1	0.9	**1.1**	**0.9**	**1.1**
Gross fixed capital formation		6.2	23.9	5.6	0.9	12.5	1.7	**9.0**	**2.1**	**3.4**
of which: equipment		2.3	8.8	5.3	0.4	17.9	9.3	**12.1**	**0.7**	**4.0**
Exports (goods and services)		19.3	74.3	6.2	5.1	3.8	4.3	**2.6**	**1.9**	**2.7**
Imports (goods and services)		18.4	70.7	6.9	6.0	4.2	5.7	**3.4**	**2.1**	**2.7**
GNI (GDP deflator)		25.5	98.1	3.8	2.6	5.6	5.3	**2.9**	**2.2**	**2.4**
Contribution to GDP growth:	Domestic demand			4.7	3.0	4.6	2.7	**4.0**	**2.2**	**2.4**
	Inventories			0.2	1.8	-0.2	0.9	**-0.3**	**0.0**	**0.0**
	Net exports			-0.8	-0.5	-0.1	-0.8	**-0.5**	**0.0**	**0.0**
Employment				0.4	0.3	2.7	1.2	**0.7**	**0.0**	**-0.1**
Unemployment rate (a)				9.9	6.8	5.8	5.4	**5.1**	**5.4**	**5.8**
Compensation of employees / head				8.6	5.7	7.0	10.2	**7.3**	**5.8**	**5.8**
Unit labour costs whole economy				5.1	3.3	3.9	6.5	**4.7**	**3.6**	**3.2**
Real unit labour cost				0.3	1.6	0.2	1.9	**1.3**	**0.6**	**0.4**
Saving rate of households (b)				5.1	10.5	11.6	13.0	**13.4**	**13.4**	**13.9**
GDP deflator				4.8	1.7	3.6	4.5	**3.4**	**3.0**	**2.7**
Harmonised index of consumer prices				3.7	0.8	3.7	3.4	**2.4**	**2.1**	**2.2**
Terms of trade goods				0.8	1.0	0.9	0.1	**0.0**	**0.4**	**0.2**
Trade balance (goods) (c)				-11.0	-3.5	-3.5	-3.8	**-4.2**	**-4.0**	**-4.0**
Current-account balance (c)				-5.6	1.6	2.7	2.0	**1.4**	**1.6**	**1.6**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-3.8	2.6	3.6	3.4	**2.7**	**2.9**	**3.0**
General government balance (c)				0.5	-0.5	-0.8	-0.6	**-0.2**	**-0.2**	**-0.2**
Cyclically-adjusted budget balance (d)				-0.3	-0.6	-1.8	-2.2	**-1.6**	**-0.9**	**-0.5**
Structural budget balance (d)				-	-0.5	-1.8	-2.2	**-1.6**	**-0.9**	**-0.5**
General government gross debt (c)				6.5	10.2	9.3	8.4	**8.7**	**8.4**	**8.2**

(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.