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## Estonia: Nordic anaemia strains growth prospects

***Sluggish demand developments in the Scandinavian neighbourhood reduce the growth expectations for the Estonian economy for 2013. Public investment in transport and energy infrastructure triggered the revival in 2012 but will be reduced this year and thereafter. The improving situation on the labour market has allowed real wages to grow and will thus bolster household consumption developments in 2013 and 2014.***

Foreign trade developments, which had backed the economic revival in 2010-2011, were adversely affected in 2012 by the remarkable slowdown of demand growth from Estonia's two most important trading partners, Finland and Sweden. Especially producers in the electronics industry, Estonia's major export sector, suffered. Although towards the end of 2012 some stabilization in foreign trade could be observed, we expect export growth to further slow down throughout the first half of 2013, driven by low expectations for recovery in the Nordic trade partners and the eurozone in general. However, as in 2012, the still more lively economic activity in the Baltic neighbours and especially in Russia will partly compensate for the stagnating external demand in Northern and Western Europe this year. Driven by domestic demand, growth of imports will again remain above that of exports in 2013, resulting in a negative contribution of net exports to GDP growth.

The strongest impetus to economic growth in 2012 came from gross fixed capital formation. Public investments in the transport and energy infrastructure were financed by EU funds and revenues from the sales of CO<sub>2</sub> emission certificates accrued in 2011. At the same time the corporate sector refrained from upgrading its equipment given the meagre outlook for external demand conditions. Exporting firms are reporting a fall in capacity utilization towards the end of 2012. During 2013 we expect that in the second half of the year enterprises will again raise their expenditures for capital replacement, given the rather favourable corporate balance sheets. Moreover, enterprises started to increase their loan stock again in the second half of 2012. Although the real estate market has bottomed out and dwelling prices are slightly rising again, households are reluctant to increase their debt burden substantially: as a result, investments in the housing sector are picking up only

slightly. In general we expect growth in fixed investments to decline in 2013, since many of the government-financed infrastructure projects are to be completed this year.

The lively demand developments on the domestic market resulted in an improved situation on the labour market throughout 2012. Jobs in higher-skill service sectors and transport are still flourishing. At the same time employment in industrial sectors and construction stagnated and may even decline slightly in 2013. Total employment growth amounted to 2.6% in 2012 and will still reach 1.6% in 2013. Accordingly, the unemployment rate declined to below 10% in the second half of 2012. However, given the slowdown of economic activity, the decline in vacancies in past months and the high share of long-term unemployed (86%) in total unemployment, a further recovery of the labour market will take place only gradually in 2013 and also beyond.

In line with the recovery of the labour market, the increase in gross wages rose to almost 6% in nominal terms and 2% in real terms in 2012. We expect the rise in labour costs to act as a driver of overall price developments in 2013. Moreover, the completion of the opening of the electricity market in January this year will most likely cause a rise in the price of electricity for households of about 20% on average. This is likely to bring about an additional increase in consumer prices by up to one percentage point in 2013. Only in 2014, when the EstLink 2 cable – which will triple the transport capacity of electricity between the Estonian and the Finish grid – is to be launched, a slight fall in electricity prices is to be expected. Moreover, excise taxes on alcohol and tobacco are to be raised this year. However, given the low price increases of imports and the expected fall of the price of oil and gas, the consumer inflation rate is to fall slightly to 3.8% in 2013.

In spite of stagnant developments in the manufacturing and construction sectors the consumption activity of Estonian households remained rather lively also in the second half of last year. Consumer surveys show that spending plans have not deteriorated, while deleveraging of households has bottomed out. Thus we expect that also in 2013 domestic consumption will grow by 3.7% in real terms and thus substantially reinforce overall GDP growth.

Apart from the increase in excise taxes and a reduction of the unemployment insurance premium rates from 4.2% to 3% of labour costs, the 2013 budget approved last December does not foresee any major changes in the tax code. The Estonian government plans to cut the budget deficit from about 1.2% in 2012 to 0.7% in 2013. In the medium run, the government's fiscal strategy foresees a reduction of the share of general government revenues in GDP from 40% in 2012 to about 35% in the year 2016. The outspoken aim is

a shift of the tax burden from labour to consumption which is to be effected inter alia by a reduction of the flat rate of the income tax from 21% today to 20% in 2015 and an increase of the tax-free minimum level in income taxation. At the same time the Estonian government aims at returning to a budget surplus in 2014. The most prominent measure cited on the expenditure side to bring down the share of the state in the economy is to gradually reduce public investments from more than 6% of GDP in 2012 to below 1.5% of GDP in 2016 – which seems unrealistic and would be detrimental to future growth prospects.

Given the meagre outlook for external demand in Northern Europe and the planned cutback in public investments, which had supported the overall economic activity in 2012, we expect GDP growth to slow down slightly in 2013 to 2.8%. The most likely scenario for the subsequent years is a restrained revival in the eurozone starting towards the end of 2013. Thus, external demand and corporate sector investments alike should somewhat speed up economic activity also in Estonia, resulting in GDP growth of 3.5% in 2014 and 3.8% in 2015. However, private consumption will remain an important pillar of economic activity in particular since deleveraging of households has bottomed out.

Table EE

### Estonia: Selected Economic Indicators

	2008	2009	2010	2011	2012 <sup>1)</sup>	2013	2014	2015
						Forecast		
Population, th pers., average <sup>2)</sup>	1340.7	1340.3	1340.2	1294.7	1294.0	1293	1292	1290
Gross domestic product, EUR mn, nom.	16235	13762	14323	15951	17200	18400	19800	21500
annual change in % (real)	-4.2	-14.1	3.3	8.3	3.2	2.8	3.5	3.8
GDP/capita (EUR at exchange rate)	12100	10300	10700	12300	13300	.	.	.
GDP/capita (EUR at PPP)	17200	14700	15500	17500	18400	.	.	.
Consumption of households, EUR mn, nom.	8689	7271	7287	7929	8500	.	.	.
annual change in % (real)	-5.4	-15.2	-2.4	3.6	3.5	3.7	3.8	4.0
Gross fixed capital form., EUR mn, nom.	4920	2949	2733	3460	4400	.	.	.
annual change in % (real)	-13.3	-38.3	-7.4	25.7	23.0	9.0	11.0	12.0
Gross industrial production								
annual change in % (real)	-5.2	-24.0	23.6	16.8	-0.5	3.0	8.0	10.0
Gross agricultural production (EAA)								
annual change in % (real)	-1.1	2.8	-4.0	9.7	0.9	.	.	.
Construction industry								
annual change in % (real)	-13.3	-29.8	-8.5	26.7	19.0	.	.	.
Employed persons, LFS, th, average	656.5	595.8	570.9	609.1	625.0	635	645	655
annual change in %	0.2	-9.2	-4.2	6.7	2.6	1.6	1.6	1.6
Unemployed persons, LFS, th, average	38.4	95.1	115.9	86.8	71.0	66.7	63.8	57.0
Unemployment rate, LFS, in %, average	5.5	13.8	16.9	12.5	10.2	9.5	9.0	8.0
Reg. unemployment rate, in %, end of period	4.6	13.3	10.1	7.3	6.0	.	.	.
Average gross monthly wages, EUR	825	784	792	839	889	.	.	.
annual change in % (real, gross)	3.2	-4.9	-1.8	0.9	2.0	.	.	.
Consumer prices (HICP), % p.a.	10.6	0.2	2.7	5.1	4.2	3.8	4.0	4.5
Producer prices in industry, % p.a.	8.0	0.7	3.2	4.3	2.6	.	.	.
General government budget, EU-def., % of GDP								
Revenues	36.7	43.5	40.8	39.4	40.3	39.5	39.0	39.0
Expenditures	39.7	45.5	40.7	38.3	41.5	40.3	39.0	38.5
Net lending (+) / net borrowing (-)	-2.9	-2.0	0.2	1.2	-1.2	-0.8	0.0	0.5
Public debt, EU-def., % of GDP	4.5	7.2	6.7	6.1	10.5	11.0	10.5	9.0
Central bank policy rate, % p.a., end of period <sup>3)</sup>	7.02	2.83	0.92	1.00	0.75	.	.	.
Current account, EUR mn	-1486	470	420	339	-350	-500	-700	-900
Current account, % of GDP	-9.2	3.4	2.9	2.1	-2.0	-2.7	-3.5	-4.2
Exports of goods, BOP, EUR mn	8490	6460	8770	12056	12600	13000	14000	15200
annual growth rate in %	4.4	-23.9	35.8	37.5	4.5	3.0	8.0	9.0
Imports of goods, BOP, EUR mn	10531	7051	9035	12277	13500	14300	15500	17000
annual growth rate in %	-2.3	-33.0	28.1	35.9	10.0	6.0	8.0	10.0
Exports of services, BOP, EUR mn	3601	3200	3442	3900	4250	4500	4900	5350
annual growth rate in %	9.5	-11.1	7.6	13.3	9.0	6.0	9.0	9.0
Imports of services, BOP, EUR mn	2286	1809	2102	2660	3050	3350	3800	4300
annual growth rate in %	1.7	-20.9	16.2	26.5	14.7	10.0	13.0	13.0
FDI inflow, EUR mn	1181	1325	1207	185	1000	1000	.	.
FDI outflow, EUR mn	761	1115	106	-1049	360	500	.	.
Gross reserves of NB excl. gold, EUR mn <sup>4)</sup>	2814	2758	1904	150	218	.	.	.
Gross external debt, EUR mn	19025	17204	16402	15504	16400	.	.	.
Gross external debt, % of GDP	117.2	125.0	114.5	97.2	95.3	.	.	.
Purchasing power parity EUR/EUR	0.7020	0.6966	0.6906	0.7044	0.7243	.	.	.

Note: Gross industrial production, construction output and producer prices refer to NACE Rev. 2. Gross agricultural production refers to Economic Account of Agriculture (EAA).

1) Preliminary and wiiw estimates. - 2) From 2011 according to census March 2011. - 3) From 2011 official refinancing operation rates for euro area (ECB), TALIBOR one-month interbank offered rate before (Estonia had a currency board). - 4) From January 2011 (Euro introduction) only foreign currency reserves denominated in non-euro currencies.

Source: wiiw Database incorporating Eurostat and national statistics. Forecasts by wiiw.