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## Estonia: Domestic demand reinforces growth

***Dwindling external demand remarkably reduces the Estonian growth expectations for 2012. However, the strong increase in employment of 2011 brings about real wage growth and hitherto domestic demand to back the business cycle. Thus, the current account turns into deficit again. An upswing of GDP growth in 2013 to 2014 is likely but depends strongly upon a revival in the Scandinavian region.***

Over the past two years, the upswing in external demand has spurred economic activity throughout the Baltics, especially in Estonia. In 2012, however, the most recent Europe-wide decline in industrial production also came to bear on Estonia's small open economy. Fortunately, the previous year's improvement in labour market conditions continues to support overall economic growth via an increase in household demand.

Growth in the exports of goods, which had already started to decline in the second half of 2011, continued slowing down in the first months of 2012. In particular, the business cycle downturn in Sweden, Estonia's main trading partner, dragged down the country's export performance. The electronics sector, in particular, was hit hard, with industrial production in the first quarter 2012 even declining by 1.8% year-on-year. Forecasts for Scandinavia for the next two years, however, are fuelling expectations that export growth will recover in 2013. Elcoteq, formerly the largest exporter of electronic equipment in Estonia, whose parent company went bankrupt in October 2011, has been taken over by Eolane, a French-owned company. The product range will be broadened to include medical equipment and there are plans to increase the workforce.

Weakening external demand has already affected the Estonian labour market. Whereas in 2011 economic recovery led to substantial employment growth (6.7%), by the end of 2011 and at the beginning of 2012 job creation had already ground to a halt, especially in the industrial sectors. The unemployment rate, which also increased slightly to 11.5% in the first quarter 2012 owing to seasonal fluctuations over the past six months, is now only expected to drop gradually over the rest of the current year and the years thereafter. That notwithstanding, the remarkable recovery in 2011 brought about an increase in average

real net wages for the first time since 2008. A growth rate of 2% is to be expected for 2012 as a whole.

Domestic demand can thus be seen to be boosting economic growth in Estonia. Household consumption remained resilient in the first quarter 2012. However, retail figures and consumer surveys indicate that in the months to come, the growth rate of domestic consumption will start slowing down. Households and enterprises alike are still in the process of deleveraging, which will also reduce the country's gross external debt.

In addition to household demand, gross fixed capital investment, particularly in the area of construction and refurbishment of buildings, is also driving growth. Public investment will increase over the current year as well as in 2013 on account of the government having committed itself to investing the revenues accruing from the sale of CO<sub>2</sub> emission certificates in 2011. Moreover, real estate prices bottomed out in 2011; they have since started to rise again, indicating that the housing market has shifted out of the trough. Real growth in the construction sector is thus expected to remain relatively lively in 2012.

Rising wages have brought about an increase in core inflation in Estonia. However, at present the only additional drivers of consumer prices are oil-related products, the effect of which will fade in the second half of the year. Consumer inflation, which still stood at 4.6% in the first quarter 2012, is thus expected to slow down on average to 3.8% for 2012 as a whole.

After two years of balanced budgets, the Estonian government will end the fiscal year 2012 with a deficit of about 2.5% of GDP. Aside from the government's commitment to invest the revenue from the trade in CO<sub>2</sub> emissions, the deficit will also accrue on account of the restoration of the public contributions to the second pillar pension fund, which had been suspended during the economic crisis. Since both are one-off factors, the deficit will decline substantially in 2013, although public wages are expected to rise more perceptibly next year.

The medium-term economic outlook for 2013 and 2014, however, is rife with uncertainty. First of all, the Estonian economy depends heavily on the business cycle in Scandinavia. The forecast rise in the real GDP growth to 3.7% in 2013 and 4.4% in 2014 is, however, predicated on a recovery in exports to Sweden and Finland. Given the improvements in the labour market, household demand will also continue to drive growth in Estonia. Furthermore, we expect the deleveraging process in the household sector to come to a halt by 2013; that should lend further momentum to household consumption and

investment activities. One outcome of the more rapid growth in domestic demand that has already become apparent this year is the return of current account deficits. Once again, they will rise to a level between 4% and 5% of GDP in both the current year and the two following years.

Table EE

### Estonia: Selected Economic Indicators

	2008	2009	2010	2011 <sup>1)</sup>	2011 1st quarter	2012	2012 Forecast	2013	2014
Population, th pers., average <sup>2)</sup>	1340.7	1340.3	1340.2	1295.5	.	.	1287	1281	1274
Gross domestic product, EUR mn, nom.	16304	13840	14305	15973	3617	3876	16900	18200	19800
annual change, % (real)	-3.6	-14.3	2.2	7.6	9.5	3.6	2.1	3.7	4.4
GDP/capita (EUR at exchange rate)	12200	10300	10700	12100	.	.	.	.	.
GDP/capita (EUR at PPP)	17300	14900	15700	17700	.	.	.	.	.
Consumption of households, EUR mn, nom.	8657	7201	7235	7917	1915	2057	.	.	.
annual change in % (real)	-6.4	-16.1	-1.7	4.4	3.7	3.2	2.8	3	4
Gross fixed capital form., EUR mn, nom.	4847	2973	2694	3434	691	799	.	.	.
annual change in % (real)	-15.1	-37.8	-9.1	26.8	20.6	17.2	10	10	12
Gross industrial production									
annual change in % (real)	-5.2	-24.0	23.6	16.8	29.9	-1.8	1	8	10
Gross agricultural production (EAA)									
annual change in % (real)	-1.2	2.8	-4.0	3.0	.	.	.	.	.
Construction industry									
annual change in % (real)	-13.3	-29.8	-8.5	26.7	34.4	27.9	.	.	.
Employed persons - LFS, th, average	656.5	595.8	570.9	609.1	591.3	614.3	625	640	655
annual change in %	0.2	-9.2	-4.2	6.7	6.8	3.9	3	2	2
Unemployed persons - LFS, th, average	38.4	95.1	115.9	86.8	99.3	79.6	.	.	.
Unemployment rate - LFS, in %, average	5.5	13.8	16.9	12.5	14.4	11.5	11	9.5	9
Reg. unemployment rate, in %, end of period	4.6	13.3	10.1	7.3	10.2	7.5	.	.	.
Average gross monthly wages, EUR	825	784	792	831	792	847	.	.	.
annual change in % (real, gross)	3.2	-4.9	-1.8	-0.1	-0.8	2.4	2	.	.
Consumer prices (HICP), % p.a.	10.6	0.2	2.7	5.1	5.2	4.6	3.8	3.8	4
Producer prices in industry, % p.a.	8.0	0.7	3.2	4.3	4.9	3.6	.	.	.
General governm. budget, EU-def., % GDP									
Revenues	36.5	43.2	40.9	39.2	35.4	.	39.0	39.0	39.0
Expenditures	39.5	45.2	40.6	38.2	37.5	.	41.5	40.0	39.0
Net lending (+) / net borrowing (-)	-2.9	-2.0	0.3	1.0	-2.1	.	-2.5	-1.0	0.0
Public debt, EU-def., in % of GDP	4.5	7.2	6.7	6.0	6.5	.	10	11.5	11
Central bank policy rate, % p.a., end of period <sup>3)</sup>	7.02	2.83	0.92	1.00	1.00	1.00	.	.	.
Current account, EUR mn	-1577	513	513	506	-53	-323	-800	-700	-800
Current account in % of GDP	-9.7	3.7	3.6	3.2	-1.5	-8.3	-4.7	-3.8	-4.0
Exports of goods, BOP, EUR mn	8542	6551	8777	12095	2752	2987	13000	14500	16500
annual growth rate in %	5.0	-23.3	34.0	37.8	54.6	8.5	7	12	14
Imports of goods, BOP, EUR mn	10664	7109	9028	12277	2865	3210	13850	15900	18800
annual growth rate in %	-1.0	-33.3	27.0	36.0	49.9	12.0	13	15	18
Exports of services, BOP, EUR mn	3537	3174	3422	3936	774	863	4300	4800	5500
annual growth rate in %	7.5	-10.3	7.8	15.0	10.6	11.5	9	12	15
Imports of services, BOP, EUR mn	2293	1815	2109	2681	565	724	3300	3800	4400
annual growth rate in %	2.0	-20.8	16.2	27.1	21.5	28.2	23	15	16
FDI inflow, EUR mn	1181	1323	1162	130	419	261	.	.	.
FDI outflow, EUR mn	761	1115	100	-1046	224	94	.	.	.
Gross reserves of NB excl. gold, EUR mn <sup>4)</sup>	2814	2758	1904	150	155	202	.	.	.
Gross external debt, EUR mn	19025	17204	16402	15504	16238	15784	.	.	.
Gross external debt in % of GDP	116.7	124.3	114.7	97.1	101.7	93.4	.	.	.
Purchasing power parity EUR/EUR	0.7020	0.6922	0.6808	0.6962	.	.	.	.	.

Note: Estonia has introduced the Euro from 1 January 2011. Up to and including 2010 all time series in EKK as well as the exchange rates and PPP rates have been divided for statistical purposes by the conversion factor 15.6466 (EKK per EUR) to a kind of statistical EUR (euro-fixed). 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. - 2) From 2011 according to census March 2012. - 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.