ESTONIA: Government uses fiscal space to support a bounce-back

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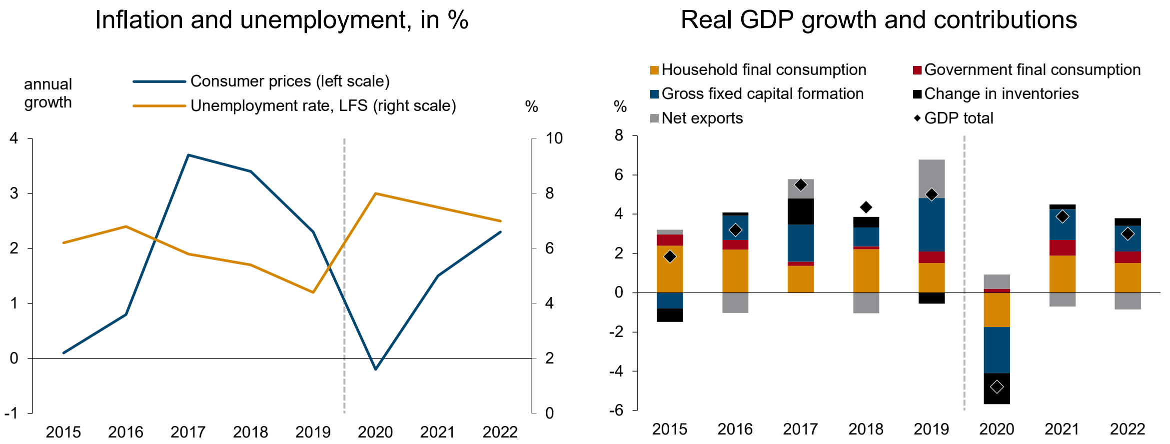
The economic slump of March-May 2020 was short-lived and was followed by an upswing in external and household demand. Nevertheless, the second wave of infections is likely to result in restrained economic activity in the coming months. A substantial government rescue package helped to cushion the downturn, and the medium-term budget strategy envisages further substantial public support for economic growth. We project a recession of 4.8% of GDP in 2020, followed by a revival of 3.9% in 2021 and a smaller upswing of 3% in 2022.

Figure 4.7 / Estonia: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

Estonian GDP contracted by 6.9% in the second quarter of 2020, but the economy bounced back remarkably in the following months. The first half of this year showed strongly declining investments and imports, which collapsed even more than exports. Household consumption, however, declined less than expected. The second wave of infections, in autumn, has also hit Estonia; however, with about 25 cases per million inhabitants in mid-October (average over previous week), the country is so far performing better than all other EU countries in this respect.

Following a slump in foreign trade in April to May, things stabilised in the following months. We expect the decline in goods exports to be 2.7% in nominal terms in 2020 – smaller than previously anticipated and fairly limited by European standards. The main reason is that the economies of Sweden and Finland – Estonia's main trading partners – are likely to perform better than the EU average, with a fall in GDP of about 5% in 2020. In particular, demand from Sweden will become quite lively, pushed along by the country's substantial fiscal support measures. Simultaneously, imports are falling more than exports this year, since entrepreneurs run down their stock of inputs in uncertain times. Moreover, households are reluctant to spend on imported durable consumer goods. A similar development can be observed in the case of services. Particularly in transport, construction and business services, imports are declining much more than exports. Tourism income has dwindled and will remain minimal this year and in the first half of 2021. At 5.5% of GDP, service exports by the tourism sector are about as important for the Estonian economy as they are for Spain, Austria or Slovenia. We should not expect a V-shaped development of goods and services exports in 2021; however, a substantial recovery is likely next year, given the fiscal stimulus in the EU to get the economy back on track.

Household consumption shrank by almost 7% in the second quarter of 2020; however, monthly retail trade figures show that it has already recovered. Although the containment measures taken by the Estonian government were laxer than in other countries in the lockdown period (e.g. shops outside malls did not have to close, and restaurants and bars could stay open till 10 p.m.), a slump in consumer spending could not be prevented in March-May. Forward-looking consumer confidence indicators and business sentiment figures suggest that households have regained their good spending mood and are only cautious about spending on durables at the moment. Overall, consumption will continue as a driver of growth in the coming two years.

Having surged in 2019, investment activity was expected to decline this year even prior to the pandemic. In the first half of 2020, in total it decreased by 11.6% year on year. In particular, businesses spent less on buildings and on upgrading their vehicle fleets, whereas investment in machinery and other equipment remained relatively stable. Looking ahead, enterprises will remain reluctant to invest until a vaccine is available that can ensure herd immunity. Investment by households – i.e. private housing construction – will also remain depressed in coming years. After a slump in the second quarter, new mortgage loans stabilised again in August 2020. House prices are still growing year on year. However, we expect households to become more cautious in the case of real estate acquisition.

Immediately after implementing the lockdown measures, the Estonian government announced a rescue package worth no less than 7% of GDP. In particular, it included subsidies for short-time work schemes, state loans to businesses and state guarantees for loans already issued. Moreover, it was announced that public investments would be front-loaded. Additional support measures were implemented for the sectors of tourism, agriculture and food production, and the government increased its share capital in the Estonian airline Nordica, which will keep it going until next summer. In April 2020, a supplementary budget was passed that envisages a budget deficit of 10% of GDP in 2020. However, given the improvement in the growth forecast, the shortfall in tax revenues and social security contributions will be less. Thus, we expect the final budget deficit to be only 8% by the end of the year. The 2021 government budget envisages a further rise in the ratio of public investments from 4.9% of GDP (2019) and 6.3% (2020), to 6.6% in 2021. The focus will be on modernising hospitals and improving the digital capacity of the economy. The budget deficit is planned to stay above 3% until 2024.

After a sharp increase to 8% in June 2020, the unemployment rate has since remained at that level. We expect the same rate for the year as a whole (according to the Labour Force Survey). Employment fell considerably in domestic trade, transport and accommodation, while remaining stable in manufacturing and construction. In the short to medium term, the government's short-time work scheme has helped to contain job losses. However, in the coming months the bankruptcy of ever more enterprises will be unavoidable – not only in the service sector, but also in production. Since households on low incomes will be the worst affected, the social safety net needs to be strengthened in order to deal with longer phases of joblessness, since unemployment benefits are rather low. In the coming two years, however, we expect an amelioration of the labour market situation, with gradually falling unemployment rates.

Given the considerable rise in unemployment, we expect wages to increase by only 2% in real terms in 2020. The government's short-time work scheme encourages enterprises to reduce the wages of at least 30% of staff by at least 30% (or down to the minimum wage) as one of the options for qualifying to receive subsidies. Thus, in those sectors hit hardest by the crisis, a decline in average wages could already be observed in the second quarter of 2020, compared to the same period last year; meanwhile, in other industries (e.g. ICT, finance, utilities), the considerable rise in wages seen in previous years as a result of skills shortages continues. The government has announced a freeze on the salaries of teachers for a couple of years, and this may be applied to other groups of public employees. Core inflation will fall throughout the year: the rise in consumer prices started to turn negative in March, largely due to the falling price of imported goods, particularly fuel. This will result in overall deflation in 2020, while we expect a revival of consumer inflation in 2021 and thereafter, on the back of rising import prices and accelerated real wage growth.

Since our interim forecast in spring, we have become more optimistic, increasing the forecast GDP growth rate for 2020 from -7% to -4.8% on the back of a stabilisation in foreign demand in recent months and resurgent household consumption. The government's budget plan for the coming years shows a willingness to use the fiscal space in order to boost investment for a longer time and buoy up the income of households. Our base scenario rests upon the assumption of a rollout of a vaccine in the coming year that will enable herd immunity to be attained within a relatively short time. Thus, a rebound in all demand categories of GDP, except net exports, is likely. Consequently, we forecast a revival of GDP growth of 3.9% in 2021, and another 3% in 2022.

Table 4.7 / Estonia: Selected economic indicators

	2017	2018	2019 1)	2020 1Q	2020 2Q	2020 1-2Q	2020	2021 Forecast	2022
Population, th pers., average	1,317	1,322	1,327	.	.	1,325	1,335	1,340	1,342
Gross domestic product, EUR mn, nom.	23,858	25,938	28,112	6,537	6,446	12,983	26,700	28,100	29,600
annual change in % (real)	5.5	4.4	5.0	-0.7	-6.9	-3.9	-4.8	3.9	3.0
GDP/capita (EUR at PPP)	23,220	24,690	26,100	.	.	.	.	.	.
Consumption of households, EUR mn, nom.	11,613	12,592	13,315	3,224	3,004	6,228	.	.	.
annual change in % (real)	2.8	4.6	3.1	1.4	-8.7	-3.8	-3.7	4.0	3.2
Gross fixed capital form., EUR mn, nom.	5,940	6,377	7,369	1,508	1,609	3,117	.	.	.
annual change in % (real)	7.8	3.9	11.1	-7.1	-15.4	-11.6	-9.0	6.0	5.0
Gross industrial production									
annual change in % (real)	4.1	4.7	-0.1	-6.5	-2.5	-9.7	-6.0	4.0	3.0
Gross agricultural production									
annual change in % (real)	6.5	-6.3	23.6	.	.	.	.	.	.
Construction industry									
annual change in % (real)	21.5	12.3	3.2	7.3	-8.4	-1.8	.	.	.
Employed persons, LFS, th, average	658.6	664.7	671.3	670.3	643.9	667.7	668	670	675
annual change in %	2.2	0.9	1.0	1.3	-1.2	0.4	-0.5	0.3	0.7
Unemployed persons, LFS, th, average	40.3	37.7	31.3	35.0	49.4	42.2	58	54	51
Unemployment rate, LFS, in %, average	5.8	5.4	4.4	5.0	7.1	6.1	8.0	7.5	7.0
Reg. unemployment rate, in %, eop 2)	4.8	4.8	5.3	6.3	7.8	7.8	.	.	.
Average monthly gross wages, EUR	1,221	1,310	1,407	1,404	1,433	1,419	1,430	1,500	1,590
annual change in % (real, gross)	3.0	3.8	5.0	3.1	2.5	2.6	2.0	3.4	3.4
Average monthly net wages, EUR	986	1,070	1,150	1,149	1,172	1,161	1,170	1,220	1,290
annual change in % (real, net)	3.2	5.0	5.1	3.4	2.3	2.8	2.2	2.7	3.0
Consumer prices (HICP), % p.a.	3.7	3.4	2.3	1.0	-1.6	0.0	-0.2	1.5	2.3
Producer prices in industry, % p.a.	3.3	3.9	-0.6	-4.9	-2.8	-4.8	-2.2	1.0	3.0
General governm. budget, EU-def., % of GDP									
Revenues	38.4	38.7	38.6	.	.	.	39.0	39.0	38.8
Expenditures	39.2	39.3	38.9	.	.	.	45.0	43.0	40.8
Net lending (+) / net borrowing (-)	-0.8	-0.6	-0.3	.	.	.	-8.0	-4.0	-2.0
General gov.gross debt, EU def., % of GDP	9.3	8.4	8.4	.	.	.	15.0	18.0	19.0
Stock of loans of non-fin.private sector, % p.a.	0.7	5.1	3.3	3.9	1.9	1.9	.	.	.
Non-performing loans (NPL), in %, eop	0.8	0.5	0.5	0.5	0.5	0.5	.	.	.
Central bank policy rate, % p.a., eop 3)	0.00	0.00	0.00	0.00	0.00	0.00	.	.	.
Current account, EUR mn	546	238	553	281	316	597	820	470	220
Current account, % of GDP	2.3	0.9	2.0	4.3	4.9	4.6	3.1	1.7	0.7
Exports of goods, BOP, EUR mn	11,964	12,592	13,316	3,273	2,953	6,227	12,700	13,200	13,900
annual change in %	6.5	5.2	5.8	-1.9	-13.1	-7.6	-4.6	3.9	5.3
Imports of goods, BOP, EUR mn	12,873	13,816	14,207	3,282.5	2,977	6,260	13,300	14,100	15,200
annual change in %	6.8	7.3	2.8	-3.6	-18.6	-11.4	-6.4	6.0	7.8
Exports of services, BOP, EUR mn	6,082	6,633	7,180	1,516	1,199	2,715	5,800	6,400	7,100
annual change in %	10.3	9.1	8.3	4.5	-36.2	-18.4	-19.2	10.3	10.9
Imports of services, BOP, EUR mn	4,229	4,739	5,161	1,070.8	800	1,871	4,000	4,600	5,100
annual change in %	8.1	12.1	8.9	-1.1	-38.7	-21.6	-22.5	15.0	10.9
FDI liabilities, EUR mn	1,552	1,022	2,627	721	194	915	1800	.	.
FDI assets, EUR mn	613	-197	1,640	289	-284	5	100	.	.
Gross reserves of NB excl. gold, EUR mn	279	651	1,256	1,418	1,678	1,678	.	.	.
Gross external debt, EUR mn	19,766	19,886	20,653	21,214	24,172	24,172	20,800	21,900	23,700
Gross external debt, % of GDP	82.8	76.7	73.5	79.5	90.5	90.5	78.0	78.0	80.0

1) Preliminary. - 2) In % of labour force (LFS). - 3) Official refinancing operation rate for euro area (ECB).

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