ESTONIA: Heading into the unknown

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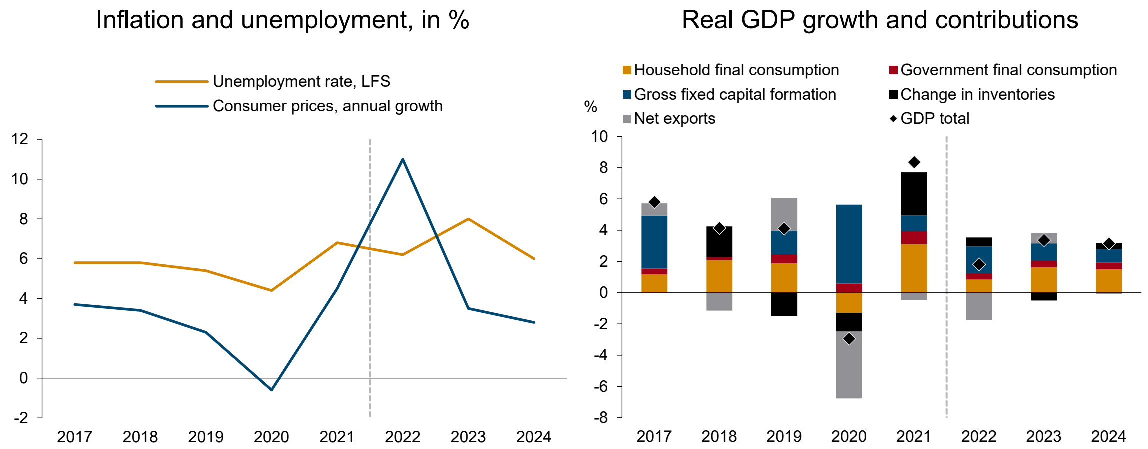
Economic performance in 2021 exceeded all expectations, with 8.3% GDP growth. This was steered by strong consumption, massive production expansion and a strengthening position on the global market. Yet the war has been a turning point. Because the Estonian economy started the year in excellent shape, economic recession will likely be avoided. However, real economic growth will fall to 1.8% in 2022, due mainly to rapid price rises, supply-side issues, disruptions to exports and a lack of major one-off investment – all magnified by the immense geopolitical uncertainty.

Figure 4.7 / Estonia: Main macroeconomic indicators



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

By the end of 2021, the Estonian economy was motoring in top gear, with growth reaching 8.3% as the economy bounced back from the COVID-19 crisis faster than nearly any other EU country. The utilisation of spare capacity, the expansion of its export portfolio in highly technological segments with greater value added, the combating of unemployment via the rapid redistribution of the workforce across sectors, and support for consumption – these were the main pillars on which the Estonian economy's striking success rested in 2021. While supply-side issues and the cross-sectoral economic imbalance caused by COVID-19 continued throughout last year, they could not hold back the positive momentum. But the war launched by Russia against Ukraine is one setback too far.

The consequences of the war for the Estonian economy will extend far beyond disruption to trade and higher energy prices. The disruption to business dealings with Russia, Belarus and Ukraine, including trade, will have only a moderate direct effect on the Estonian economy: the Russian market, for instance, accounted for less than 3% of total exports of Estonian origin in 2021. However, the disruption to supply chains, the uncertain outlook for investment and the jobs that will be affected are all of greater concern. Ukraine was a major exporter of wood, construction materials and agricultural products, and the first signs of looming deficit are already appearing, as ongoing constructions projects are delayed. The war may dent the country's rock-solid attractiveness to investors, given its geographical proximity of Russia, with the negative effect most evident in its eastern regions. While NATO's commitment to protect its members in the event of direct military aggression remains strong, the US elections on the forecast horizon sow a seed of doubt about future developments.

Inflation is no longer forecast to slow. The cost of a 'shopping basket' rose by 15.2% year on year in March, with the lion's share of the price hike stemming from energy and food. While previous forecasts projected a gradual decline in energy prices by summer 2022 and a diminishing snowball effect on the cost of food and commodities, the war has thrown this forecast into reverse. Inflation will likely remain at around 11% in 2022, with a subsequent decline to 3.5% in 2023 and 2.8% in 2024.

Despite remaining steadily high, income growth will not keep pace with price rises in 2022, so purchasing power will shrink. The increase in private consumption hit 6.5% year on year in 2021. With wage growth at 7.3% quarter on quarter in Q4, and with EUR 1.3bn withdrawn from the second pension pillar since pension reform was introduced (with around a fifth going on consumption), purchasing power was running strong up until February. But it will see a substantial setback in 2022. However, it is not solely inflation that is to blame for declining household and business demand: the war is holding back economic growth, as consumers and businesses become increasingly cautious. Higher prices per se yield less consumption; however, the undermining of consumer confidence in the face of war causes private demand to deteriorate even further and the consumption pattern to change.

Foreign trade witnessed a broad-based recovery in 2021, with exports of goods and services 23% higher in constant prices in Q4 2021 than the previous year. As forecast earlier, both imports and exports largely recovered from the big hit caused by the pandemic; yet the growth at the end of 2021 was partly due to the rapidly rising prices of both exports and imports, a low reference base and Estonia's improving position on the global market. That final element was largely thanks to an increased share of products in those sectors with greater value added and higher productivity. Moreover, the export of wood, wood products, machinery and equipment, and mineral products grew sharply. With their exports to Russia, Belarus and Ukraine falling off a cliff, Estonian companies will have to seek new markets and suppliers. But with every other country facing the same problem, adjustment to the new reality will take some time and will result in foreign trade losing momentum in 2022.

Those resources left idle during the pandemic were fully utilised in 2021. This makes further growth heavily dependent on new investment and on resolving the supply-side issues caused by the war. By the end of 2021, the Estonian economy was approaching its potential output, so that further growth would in any event have required investment. By that stage, labour shortages had been partly smoothed via the effective reallocation of labour from those sectors hit hard by the pandemic to those industries that were performing well and had increased demand for labour. With the escalating uncertainty, the investment outlook is now unsettled. But one thing is certain: no large one-off inflows of foreign direct investment like that streamed by the VW Group in 2020-2021 are expected in 2022.

Cost considerations outweigh the environmental hazards of oil shale, as energy prices rise and the price of CO_2 quotas falls. Long-criticised, environmentally hazardous oil shale production is gaining economic competitiveness and public acceptance. With almost 90% of Estonian energy generated using petroleum and gas derived from oil shale, the looming energy crisis, amplified even further by the war, will likely push environmental considerations into the shadows, at least in the short term. This is expected to ease the burden of energy costs for households and provide a boost to economic growth.

The unemployment rate fell to 5.2% in Q4 2021, signalling that the labour market was on the right track; but this will likely change. We project 8% unemployment in 2022, with two major factors causing a surge over the upcoming months: an influx of Ukrainians seeking protection in Estonia and redundancies caused by the war. With a large proportion of the expected 30,000 Ukrainian refugees hoping to remain economically active, integrating them will take time and will require additional infrastructural expenditure on child care and education – the most crucial factors in keeping mothers economically active. Similarly, those workers whose jobs have been directly affected by business closures or the suspension of operations – potentially up to 10,000 employees – may need to be reallocated across sectors. But the recent successful cross-sectoral redistribution of labour in response to the various effects of the pandemic could prove beneficial in combating the war-induced upswing in unemployment.

Nominal wage growth was 7.3% quarter on quarter in Q4 2021, but the markedly high inflation means that real wage growth will falter in 2022. With rapid economic recovery, the level of incomes rose substantially in 2021, yet the rapid price advancement has led to a sharp decline in real wages since the start of 2022. With inflation forecast to stay steadily high, and with additional wage pressures stemming from the 12% hike in the minimum wage planned for 2022, we project 3% real wage growth in 2022.

The narrowing deficit in 2021 signals that the government budget is in much better shape than a year ago, but spending will increase. The general government deficit stood at 2.4% and the debt level at 18% of GDP in 2021, which was below forecast levels, largely thanks to an upswing in tax revenues towards the end of the year. However, the greater need to strengthen national security, to provide subsistence benefits in conditions of high inflation and to cover the social protection, accommodation and education of refugees will force up government spending in 2022. The imperative of breaking Estonia's dependence on Russian gas is top of the government's priorities for 2022. This will involve substantial unforeseen expense, with a large proportion of that spending going on a joint Estonian-Latvian-Finnish liquefied natural gas terminal. Consequently, the country's debt is forecast to reach 19% of GDP in 2022. As some of the major expenditure will be one-off, the state budget is expected to partially restore the balance in subsequent years, with the budget deficit declining to 15% by 2024.

Although the Estonian economy has entered this phase of immense geopolitical uncertainty in the best possible shape, the outlook is clouded by the economic consequences of the war. Given the pace of recovery, growth was anyway forecast to slow to 3.6% in 2022 and 3.0% in 2023. But with the immense additional uncertainties generated by the war, GDP growth is now forecast to be 1.8% in 2022, 3.4% in 2023 and 3.1% in 2024. Economic growth in 2022 will depend on finding substitutes for Russian imports, the magnitude of inflation, the scale of the resulting slump in consumption and, above all, developments in Ukraine, as well as on the implementation of existing (and the introduction of new) sanctions on Russia and Belarus. Yet, the economy will probably avoid recession, thanks to the strong momentum built up by its exit from the COVID-19 crisis.

Table 4.7 / Estonia: Selected economic indicators

	2018	2019	2020	2021 1)	2022	2023	2024
						Forecast	
Population, th pers., average	1,322	1,327	1,329	1,340	1,370	1,370	1,372
Gross domestic product, EUR m, nom.	25,818	27,732	26,835	30,660	34,700	37,100	39,300
annual change in % (real)	4.1	4.1	-3.0	8.3	1.8	3.4	3.1
GDP/capita (EUR at PPP)	24,640	25,790	25,160	28,200	.	.	.
Consumption of households, EUR m, nom.	12,522	13,340	12,885	14,314	.	.	.
annual change in % (real)	4.3	3.9	-2.7	6.5	1.8	3.5	3.2
Gross fixed capital form., EUR m, nom.	6,376	7,054	8,233	8,755	.	.	.
annual change in % (real)	0.0	6.1	19.9	3.3	6.0	3.9	3.0
Gross industrial production							
annual change in % (real)	4.7	6.9	-3.0	7.2	3.5	4.8	4.2
Gross agricultural production							
annual change in % (real)	-6.3	22.8	0.0	-6.7	.	.	.
Construction industry							
annual change in % (real)	12.3	5.8	-6.1	9.4	.	.	.
Employed persons, LFS, th, average 2)	664.7	671.3	656.6	654.2	660	670	670
annual change in %	0.9	1.0	-2.2	-0.5	0.2	1.5	0.7
Unemployed persons, LFS, th, average 2)	37.7	31.3	47.9	43.1	57	43	37
Unemployment rate, LFS, in %, average 2)	5.4	4.4	6.8	6.2	8.0	6.0	5.2
Reg. unemployment rate, in %, eop 3)	4.8	5.3	8.3	6.8	.	.	.
Average monthly gross wages, EUR	1,310	1,407	1,448	1,547	1,770	1,930	2,060
annual change in % (real, gross)	3.8	5.0	3.4	2.1	3.0	5.5	4.0
Average monthly net wages, EUR	1,070	1,150	1,185	1,266	1,450	1,580	1,690
annual change in % (real, net)	5.0	5.1	3.5	2.0	3.0	5.5	4.0
Consumer prices (HICP), % p.a.	3.4	2.3	-0.6	4.5	11.0	3.5	2.8
Producer prices in industry, % p.a.	3.9	-0.6	-3.5	17.2	11.0	3.4	2.6
General governm. budget, EU def., % of GDP							
Revenues	38.9	39.6	40.3	41.5	41.0	42.2	43.0
Expenditures	39.4	39.4	45.9	45.0	44.0	44.3	44.2
Net lending (+) / net borrowing (-)	-0.6	0.1	-5.6	-4.0	-3.0	-2.1	-1.2
General gov. gross debt, EU def., % of GDP	8.2	8.6	19.0	20.0	19.0	17.0	15.0
Stock of loans of non-fin. private sector, % p.a.	5.1	3.3	4.8	7.5	.	.	.
Non-performing loans (NPL), in %, eop	0.5	0.5	0.4	0.2	.	.	.
Central bank policy rate, % p.a., eop 4)	0.00	0.00	0.00	0.00	.	.	.
Current account, EUR m	206	700	-69	-348	-280	-180	-100
Current account, % of GDP	0.8	2.5	-0.3	-1.1	-0.8	-0.5	-0.3
Exports of goods, BOP, EUR m	12,593	13,340	13,387	16,306	17,000	17,900	18,600
annual change in %	5.3	5.9	0.4	21.8	4.3	5.3	3.9
Imports of goods, BOP, EUR m	13,816	14,270	13,535	17,630	18,400	19,100	19,800
annual change in %	7.3	3.3	-5.2	30.3	4.4	3.0	3.7
Exports of services, BOP, EUR m	6,634	7,195	5,713	8,407	9,100	9,700	10,100
annual change in %	8.7	8.5	-20.6	47.2	8.2	6.6	4.1
Imports of services, BOP, EUR m	4,740	5,113	5,436	6,983	7,500	8,200	8,700
annual change in %	12.1	7.9	6.3	28.5	7.4	9.3	6.1
FDI liabilities, EUR m	1,039	2,718	3,055	6,550	.	.	.
FDI assets, EUR m	-209	1,629	275	7,021	.	.	.
Gross reserves of CB excl. gold, EUR m	651	1,256	1,615	2,081	.	.	.
Gross external debt, EUR m	20,189	21,161	24,452	26,351	31,900	28,200	30,500
Gross external debt, % of GDP	78.2	76.3	91.1	85.9	92.0	86.0	83.0

1) Preliminary and wiiw estimates. - 2) From 2021 the new LFS methodology is applied in line with the Integrated European Social Statistics Regulation (IESS). - 3) In % of labour force (LFS). - 4) Official refinancing operation rate for euro area (ECB).

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