ESTONIA: No swift economic recovery on the cards

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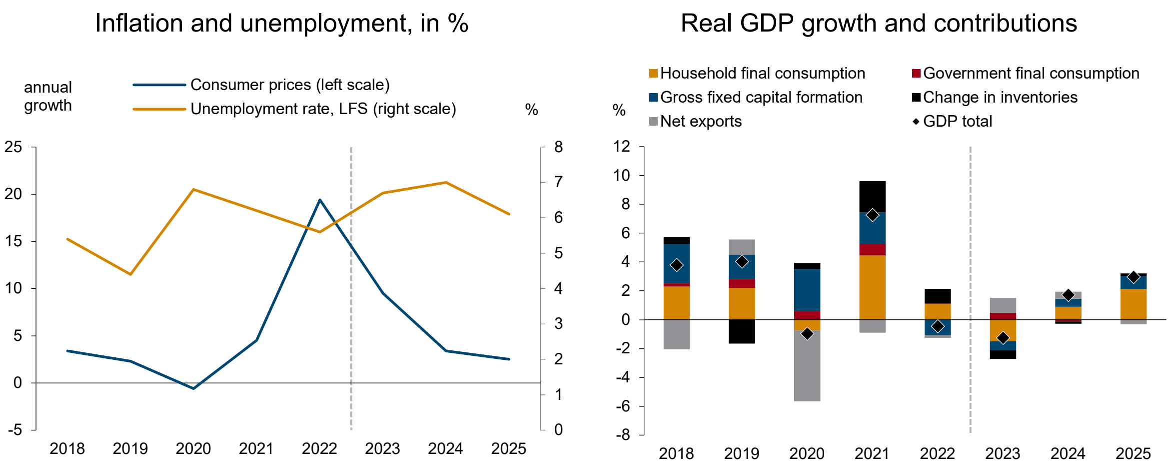
The Estonian economy performed at below the EU-CEE average in H1, and GDP is now expected to decline by 1.3% in 2023 as a whole, as the aftermath of severe inflation, major supply issues and interest rate hikes unfolds. With shrinking domestic and foreign demand, the outlook for recovery will largely be determined by the country's success in gaining a share of new markets, the resurgence of foreign direct investment and the revival of Estonian firms' competitiveness. Economic growth is expected to gain ground slowly but steadily from next year onwards, with GDP growth forecast to be 1.7% in 2024 and 3.0% in 2025.

Figure 6.7 / Estonia: Main macroeconomic indicators



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

The economic downturn is likely to ease in H2 2023, but still the economy is expected to shrink by 1.3% for the full year; this will be followed by a recovery of 1.7% in 2024 and growth of 3.0% in 2025. Estonian GDP in Q2 2023 was 0.2% lower than in Q1 – the sixth consecutive quarter of decline. The economic outlook appeared fairly optimistic at the beginning of the year, but the results from H1 2023 clearly indicate the effects of high inflation, fragmented supply chains and sluggish external demand: economic performance has ended up in the doldrums. The usual driving forces of economic resilience – steady investment inflow, good business performance and sound private consumption – have all seen a decline since the beginning of the year.

The government has largely got to grips with inflation, but there are still economic consequences to be faced. Persistent economic sluggishness over the past year, interest rate hikes and deteriorating private consumption have all served to reduce the pressure on prices, so that inflation slowed from 20% in early 2023 to 4.6% in August. Yet huge sectoral differences have emerged: the cost of energy and durable goods has fallen, while food prices have been rising steadily. Inflation is forecast to average around 9.5% in 2023, to be followed by a major slowdown to around 3.4% in 2024 and 2.5% in 2025.

The record low business sentiment is blamed on interest rate rises, steadily high input prices, a lack of state support, and declining domestic and foreign demand. Industrial production has been stuck in steady decline over 2023, and production capacities have increasingly been underutilised. Electricity production, mining (other than oil shale) and manufacturing appear to have been the worst affected, while the oil shale sector is among the few to have posted persistent growth. However, the major increase in pollution charges envisaged for next year is likely to hit the oil shale sector's performance from 2024 onwards.

The deteriorating outlook for foreign trade has dealt Estonia's open economy a powerful blow. Weakening demand for Estonian products, especially in the Scandinavian countries, is undermining the prospects for recovery. Given that approximately 40% of the value created by Estonian firms is intended for exports, the economic decline experienced by Estonia's major trading partners (including Finland, Sweden and Germany) is depriving Estonian firms of an important source of revenue.

Partly because of high inflation, the competitiveness of Estonian firms on foreign markets has been eroded, and exports are likely to decline by a further 2.4% in 2023. Likewise, imports are projected to fall by 3.6% in 2023, largely on account of slackening domestic demand. Foreign trade will start to pick up in 2024, with exports and imports growing by 2.3% and 1.7%, respectively. However, we will see the pronounced revival of exports only in 2025, since gaining a share of the new markets will take time; and to regain their competitiveness, Estonian firms first need to get their input supply and production efficiency issues sorted out. IT technologies and services will remain a cornerstone of export activity through the turbulent years ahead.

Purchasing power has weakened, as the effects of the interest rate hike bite. Challenged by extremely high inflation since mid-2022, private consumption has been losing momentum. The steady rise in food prices, the higher cost of borrowing and larger payments on outstanding loans will all lead private consumption to contract in 2023. As real wage growth is eroded by inflation, and as the private savings used to finance the rising cost of living are depleted, consumption will fall in H2: for 2023 as a whole, the decline will be around 3%. However, it will bounce back in the coming years (with 1.8% growth in 2024 and 4.3% in 2025), fuelled largely by decelerating inflation and improving economic performance.

The labour market's resilience started to flag in mid-2023, with unemployment rising gradually and layoffs reaching even the most resistant IT sector. Unemployment is expected to surge to 6.7% on average in 2023, as companies struggle to cope with the consequences of inflation, interest rate hikes, investment decline, reduced demand and rising nominal wages. As the prospects of making a profit are crucial in securing funds, it will be challenging to attract new investment – even in the IT sector, so that companies will be forced to lay off IT specialists. Unemployment will peak at 7% in 2024, and the government is considering making 2,000 public employees redundant, in an attempt to curb public spending and minimise the bureaucracy. Any revival of employment is only likely from 2025, and even then it will be fairly gradual. Moreover, the Estonian labour force will be swollen by the influx of Ukrainian refugees, and that will inflate the unemployment figures over the coming years.

Real wage growth has so far been reined in by inflation, and the declining demand for labour will impose further limits on wage rises. In nominal terms, gross monthly wages rose 12.4% year on year in Q2 2023, driven largely by an increase in public-sector wages. The private sector posted a steady increase in nominal gross wages over the year, but further developments will rely heavily on a revival of business activity, the resurgence of foreign direct investment (FDI) and a recovery in the competitiveness of Estonian firms on foreign markets.

The budget gap will not narrow within the forecast horizon, but the government is aiming at fiscal consolidation. Budget revenues are expected to surge in 2023, despite the economic downturn. This year, the government got the ball rolling on tax reform: several major changes are already under way (an increase in VAT; the elimination of tax exemptions) and several other reforms are in the pipeline (higher income tax; pollution charges). However, these have limited scope to narrow the budget deficit, which will be around 3.5% of GDP in 2023, declining to 2.7% by 2025. Government spending remains high, and further support activity is needed to stimulate economic recovery, boost the competitiveness of Estonian firms and safeguard internal security. Thus, the government has limited room for manoeuvre in reducing public spending: laying off public employees and capping wage growth in the public sector are among a few budget cuts currently being discussed.

The long-term model of Estonian economic success will probably require a rethink. Even though the current economic decline is, in all likelihood, only a temporary blip, if the country is to drag itself out of the mire and get the economy back on the track of steady growth, then a new longer-term strategy is required. The current economic outlook clearly indicates that re-establishing the competitiveness of the Estonian economy, reviving economic activity and boosting the flow of FDI are all contingent on strategic action on the part of the government and business. The new longer-term economic growth strategy should embrace several aspects: from implementing new, more efficient technologies in manufacturing, adopting green energy solutions and increasing labour productivity at all levels of business, to continuing with the reform of taxes.

Table 6.7 / Estonia: Selected economic indicators

	2020	2021	2022 1)	2022	2023	2023	2024	2025
				January-June			Forecast	
Population, th pers., average	1,330	1,331	1,349	1,332	1,366	1,350	1,349	1,347
Gross domestic product, EUR m, nom.	27,430	31,169	36,011	17,070	18,244	38,900	40,900	43,200
annual change in % (real)	-1.0	7.2	-0.5	1.6	-3.3	-1.3	1.7	3.0
GDP/capita (EUR at PPP)	25,820	28,590	30,530	.	.	.	.	.
Consumption of households, EUR m, nom.	13,168	14,991	17,933	8,444	9,349	.	.	.
annual change in % (real)	-1.5	9.3	2.3	5.8	-2.2	-3.0	1.8	4.3
Gross fixed capital form., EUR m, nom.	8,175	9,090	9,910	4,597	4,153	.	.	.
annual change in % (real)	10.8	7.3	-3.7	-13.8	-13.5	-2.2	2.0	3.2
Gross industrial production								
annual change in % (real)	-3.0	13.3	-2.0	3.8	-11.7	-2.5	5.5	3.2
Gross agricultural production								
annual change in % (real)	0.0	-4.9	5.0	.	.	.	.	.
Construction industry								
annual change in % (real)	-6.1	9.4	-1.2	4.7	-11.5	.	.	.
Employed persons, LFS, th, average 2)	656.6	654.2	680.8	676.8	701.7	690	690	700
annual change in %	-2.2	-0.5	4.1	4.8	3.7	1.2	-0.6	1.1
Unemployed persons, LFS, th, average 2)	47.9	43.1	40.2	40.7	44.7	50	52	46
Unemployment rate, LFS, in %, average 2)	6.8	6.2	5.6	5.7	6.0	6.7	7.0	6.1
Reg. unemployment rate, in %, eop 3)	8.3	6.8	7.7	6.8	7.4	.	.	.
Average monthly gross wages, EUR 4)	1,448	1,548	1,645	1,602	1,807	1,770	1,890	2,010
annual change in % (real, gross)	3.4	2.1	-6.5	-4.7	-1.1	-1.5	3.0	4.0
Average monthly net wages, EUR 4)	1,185	1,269	1,349	1,314	1,482	1,450	1,540	1,640
annual change in % (real, net)	3.5	2.3	-6.5	-4.6	-1.1	-1.7	2.9	4.0
Consumer prices (HICP), % p.a.	-0.6	4.5	19.4	16.5	14.1	9.5	3.4	2.5
Producer prices in industry, % p.a.	-3.5	17.2	36.0	40.0	2.5	9.0	3.4	2.5
General governm. budget, EU def., % of GDP								
Revenues	39.5	39.4	38.7	.	.	41.0	42.3	42.6
Expenditures	44.9	41.8	39.6	.	.	44.5	45.6	45.3
Net lending (+) / net borrowing (-)	-5.5	-2.4	-0.9	.	.	-3.5	-3.3	-2.7
General gov. gross debt, EU def., % of GDP	18.6	17.8	18.5	.	.	21.6	20.7	19.5
Stock of loans of non-fin. private sector, % p.a.	4.8	7.5	11.7	10.6	8.1	.	.	.
Non-performing loans (NPL), in %, eop	0.4	0.2	0.2	0.2	0.2	.	.	.
Central bank policy rate, % p.a., eop 5)	0.00	0.00	2.50	0.00	4.00	.	.	.
Current account, EUR m	-272	-568	-1,042	-687	91	340	470	750
Current account, % of GDP	-1.0	-1.8	-2.9	-4.0	0.5	0.9	1.1	1.7
Exports of goods, BOP, EUR m	13,290	16,367	20,091	9,662	9,237	19,100	19,620	20,930
annual change in %	-0.2	23.2	22.8	29.1	-4.4	-4.9	2.7	6.7
Imports of goods, BOP, EUR m	13,533	17,662	22,749	10,998	10,001	21,300	22,080	23,400
annual change in %	-5.0	30.5	28.8	34.9	-9.1	-6.4	3.7	6.0
Exports of services, BOP, EUR m	5,736	8,254	10,817	5,080	5,362	11,500	12,600	13,650
annual change in %	-20.3	43.9	31.1	44.2	5.6	6.3	9.6	8.3
Imports of services, BOP, EUR m	5,470	7,073	8,386	4,022	4,204	8,950	9,400	10,050
annual change in %	6.1	29.3	18.6	9.6	4.5	6.7	5.0	6.9
FDI liabilities, EUR m	3,122	6,169	1,583	-1,837	1,543	1590	.	.
FDI assets, EUR m	253	5,558	1,560	-1,072	360	1220	.	.
Gross reserves of CB excl. gold, EUR m	1,615	2,081	2,068	2,237	2,244	.	.	.
Gross external debt, EUR m	24,333	26,523	30,519	29,896	32,018	33,100	34,200	35,600
Gross external debt, % of GDP	88.7	85.1	84.7	83.0	81.5	85.0	83.5	82.4

1) Preliminary. - 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) From 2022 based on tax administration data, survey data before. - 5) Official refinancing operation rate for euro area (ECB).

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