ESTONIA: The second wave has put the brakes on economic recovery

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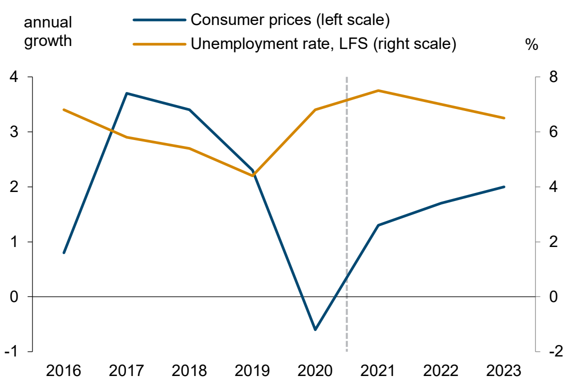
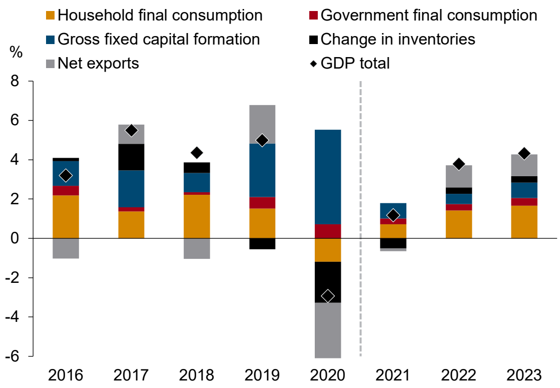
The rebound in economic activity in the second half of 2020 suggested that the Estonian economy would bounce back once the virus was contained and restrictions were removed. However, an upswing of infections at the beginning of 2021 has turned out much worse than expected and is jeopardising economic recovery. We have downgraded our GDP growth forecast to 1.2% in 2021. The economy is expected to return to its pre-crisis path only in 2022, with a 3.8% growth rate, followed by 4.3% in 2023.

Figure 4.7 / Estonia: Main macroeconomic indicators





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

A revival of economic activity, coupled with very loose restrictions in the second half of 2020, resulted in a minor fall in GDP of 2.9% for the year as a whole. Estonia has acquired a solid position as one of the EU countries least affected economically. After a slump in Q2, caused by restrained foreign trade, reduced consumption, and falling investment, the rest of the year was marked by a rapid bounce-back. The tempo of recovery in Q3 and Q4 indicated that the Estonian economy had great potential. Once the restrictions were lifted, the economy commenced a swift upturn, despite a sluggish recovery in exports and imports, a badly shaken service sector, and vulnerable consumer confidence. The country's sound banking system, combined with sufficient reserves to relaunch business activity and government support, has so far safeguarded the recovery.

The second wave of COVID-19 started to gather momentum from November 2020 and culminated in a second lockdown from 11 March. The very loose to non-existent restrictions between November 2020 and February of this year proved a double-edged sword. No doubt they fostered economic recovery momentum in Q3 and Q4; but recent developments have revealed the downside – a record high infection rate, increasing public healthcare pressure, a strict lockdown, and the inevitable risks to further recovery.

A massive rise in investments buoyed GDP growth in Q4 2020 and – for the first time in a long while – turned Estonia into a net borrower. Despite earlier forecasts, corporate and government capital investments in the second half of 2020 topped the previous year's level, boosting gross fixed capital formation by 18.4% year on year. A surge in foreign direct investment (FDI) was mostly channelled into car-production software. And an upswing in the development of various pandemic-related technologies by Estonian IT companies suggests their potential to attract FDI financing. Information technology appears to have been the sector least disrupted by the recession. Targeted investments are strengthening the position of the sector even further, fostering wage growth and increasing sectoral labour demand. We expect this trend to continue and FDI in the IT industry to fall only marginally in 2021, particularly due to the persistent relevance of technological solutions related to COVID-19.

There has been a gradual revival of foreign trade and an unforeseen current account deficit, fuelled by the extraordinary one-off import of IT services in Q4 2020. Estonia's relatively minor position on the global market and the rather good performance of its main trading partners – Finland, Latvia, and Lithuania – predetermined the relatively moderate impact that the collapse in foreign trade had on the Estonian economy. As expected, the second half of 2020 marked a gradual upturn in exports and imports of goods (electronic equipment, food) and exports of services (in the telecommunications, information, and insurance sectors). However, a stark 11% jump in foreign trade turnover in Q4 was driven by an unexpectedly large purchase of computer software, which was probably linked to the surge in FDI mentioned above. Other service imports – particularly in transport, construction, and the service sector – remained in the doldrums. External demand for information and communication technology (ICT) and insurance services is expected to ensure steady growth in the crisis period, though foreign tourism is unlikely to recover in 2021. As the crisis is dragging on and foreign demand lacks clarity, we predict moderate growth of 3.5% for exports and 3.9% for imports in 2021. A full-blooded foreign trade revival is expected to start only in 2022.

Fear matters more than restrictions, as private consumption started to shrink well before the second lockdown was announced. While overall household consumption shrank by 2.5% in 2020, a dip in retail sales was largely avoided, as that sector saw a 4.1% growth rate in Q4. Although the retail sector operated as usual throughout autumn and winter, its turnover fell in the first months of 2021. A pension system reform – designed to eliminate the mandatory second pillar – has been introduced (among other things) to provide at least a temporary consumption boost in 2021. However, in light of the restrictions currently imposed, a mounting infection rate, the uncertain vaccination outlook, and household income distortions, consumers will likely spend cautiously, and the propensity to save will remain strong in the first half of 2021. Consumer confidence indicators support this forecast, with the index slipping below the level of spring 2020. We expect a very slow recovery in household consumption, with only a 1.5% increase in 2021. Assuming good progress with the vaccination campaign, a recovery in employment, and improving consumer confidence, we expect steadier growth of 3.0% and 3.5% in the coming two years.

The rising cost of electricity has restored the consumer price index to its pre-crisis level. In December 2020, the consumer price index (CPI) was 0.8% lower than in December 2019, with goods being cheaper and services more expensive. A big hike in the cost of electricity meant that inflation stopped falling in January 2021 (0.2% higher than last year). Energy prices constitute 12% of the consumer basket in Estonia (compared to an EU average of 9%), thus any such fluctuations serve to fuel inflation. Because of the high cost of carbon dioxide quotas, the production of electricity from oil shale is limited and Estonia imports expensive electricity from the Nordic countries. The upward trend in the CPI is expected to last until summer 2021, when the exchange price for electricity will likely be adjusted. Otherwise, price pressures remain weak at the beginning of 2021, due to a slump in wage growth and cautious private consumption. We expect this to remain the case until at least the second half of the year. Service price inflation was expected to increase in the second half of 2021; but the rapid spread of the virus, the uncertain vaccination outlook and the new restrictions may push the rise back until 2022. We predict inflation of 1.3% in 2021, followed by 1.7% in 2022 and 2% in 2023.

The aftermath of the pandemic could be mounting labour market inequalities. The overall unemployment rate reached 7.8% in Q3 2020, slipping back to 7.5% by the end of the year. Job distortion appeared uneven across sectors, regions, socio-demographic groups, and types of employment. The least-protected workers – informal employees, short-time, and part-time workers – suffered massive layoffs, mainly in the construction, accommodation, and food industries. Women, young people, the Russian minority, rural dwellers, and people living in the north-eastern region stood out in terms of raised unemployment; this may serve to exacerbate the existing socioeconomic disparities even further, placing disproportionate pressure on the welfare system and hampering overall economic recovery. The persistent nature of the imbalances hints at slow labour market stabilisation and potential structural changes, if the crisis drags on. We predict that the unemployment rate will stay at around 7.5% in 2021 and will fall only marginally in the coming two years.

Wage growth in 2020 owes much to the high-tech and financial sectors. Average wages maintained a steady growth rate of 3.4% in 2020, despite increased supply and a declining demand for labour. This points towards low-income workers being the most vulnerable to layoffs and wage reductions. Highly paid workers – particularly in ICT, the financial and insurance sectors, which are on a rise, despite the crisis – are in great demand and are driving the average wage upward.

A lower-than-expected budget deficit of 5.4% of GDP in 2020 suggests that there is still fiscal space to support the economy. An increased inflow of tax revenues – mostly payroll tax and VAT – coupled with the massive sale of foreign debt securities, largely covered up the fiscal hole produced by the substantial rescue package in Q2. With the pandemic still in full swing, the government plans to freeze wage and operating costs in 2021-2024. However, a major rise in pensions and increased unemployment benefits, coupled with mounting capital investments, will keep expenditure high, which leaves very little scope for closing the budget deficit within the forecast horizon.

While this year started out with a positive outlook for economic performance in 2021, the unforeseen lockdown has cast doubt on the initial forecast of 3.9% GDP growth. We have downgraded the forecast to 1.2% GDP growth in 2021, followed by a full-scale recovery and growth of 3.8% in 2022 and 4.3% in 2023. Estonian businesses and private consumers had enough reserves to relaunch activities and facilitate a rapid bounce-back after the first wave; but there is no guarantee that the same thing will happen after the second wave: reserves and savings cannot last forever. Despite the vaccination roll-out, EU support measures to combat the crisis and a stronger overall external environment, state financial aid is needed to prevent the economy from sinking deeper into recession. This simply means that another government rescue package may be launched in spring 2021. Favourable EU funding is another possible source of support for economic recovery. EU funds largely propped up the economy in 2020, although Estonia was less dependent on EU support than other countries of Central and Eastern Europe, thanks to adequate national reserves and a well-run banking system.

Looking beyond the pandemic, a stronger position in a global value chain, broader funding options for businesses and a further strengthening of the technological sector seem likely. The crisis has placed the cornerstones of future economic development in the spotlight of political and economic debate. The crisis has showcased the importance of high-tech sectors in sustaining employment, investment, and tax revenues, proving that the focus on a technologically advanced economy is leading the country in the right direction. An educated labour force, strong technical knowledge, and an advanced level of digitalisation provide solid grounds for attracting investors and gaining a better position in a global value chain. Given the small population and the country's rather limited natural resources, it is essential to stay on the road to a sustainable science- and technology-based economy, and not to lose momentum. However, investment in innovations and technology, particularly in the private sector, remains well below the EU average, which could threaten Estonia's competitiveness in the long term.

Table 4.7 / Estonia: Selected economic indicators

	2017	2018	2019	2020 1)	2021	2022 Forecast	2023
Population, th pers., average	1,317	1,322	1,327	1,327	1,340	1,342	1,342
Gross domestic product, EUR m, nom.	23,858	25,938	28,112	27,167	27,800	29,300	31,200
annual change in % (real)	5.5	4.4	5.0	-2.9	1.2	3.8	4.3
GDP/capita (EUR at PPP)	23,280	24,680	26,110	25,890	.	.	.
Consumption of households, EUR m, nom.	11,613	12,592	13,315	12,904	.	.	.
annual change in % (real)	2.8	4.6	3.1	-2.5	1.5	3.0	3.5
Gross fixed capital form., EUR m, nom.	5,940	6,377	7,369	8,504	.	.	.
annual change in % (real)	7.8	3.9	11.1	18.4	3.0	2.0	3.0
Gross industrial production							
annual change in % (real)	4.1	4.7	-0.5	-5.2	2.0	4.0	3.0
Gross agricultural production							
annual change in % (real)	6.5	-6.3	22.8	-2.0	.	.	.
Construction industry							
annual change in % (real)	21.5	12.3	3.2	-6.0	.	.	.
Employed persons, LFS, th, average	658.6	664.7	671.3	656.0	657	665	670
annual change in %	2.2	0.9	1.0	-2.3	0.2	1.2	0.8
Unemployed persons, LFS, th, average	40.3	37.7	31.3	47.9	53	50	47
Unemployment rate, LFS, in %, average	5.8	5.4	4.4	6.8	7.5	7.0	6.5
Reg. unemployment rate, in %, eop 2)	4.8	4.8	5.3	8.3	.	.	.
Average monthly gross wages, EUR	1,221	1,310	1,407	1,448	1,520	1,610	1,700
annual change in % (real, gross)	3.0	3.8	5.0	3.4	3.4	4.0	3.8
Average monthly net wages, EUR	986	1,070	1,150	1,185	1,240	1,310	1,390
annual change in % (real, net)	3.2	5.0	5.1	3.5	3.4	4.0	3.8
Consumer prices (HICP), % p.a.	3.7	3.4	2.3	-0.6	1.3	1.7	2.0
Producer prices in industry, % p.a.	3.3	3.9	-0.6	-3.5	1.5	3.0	2.5
General governm.budget, EU-def., % of GDP							
Revenues	38.5	38.7	39.0	45.0	39.0	38.8	38.8
Expenditures	39.2	39.2	38.9	50.4	43.0	40.8	39.3
Net lending (+) / net borrowing (-)	-0.7	-0.5	0.1	-5.4	-4.0	-2.0	-0.5
General gov.gross debt, EU def., % of GDP	9.1	8.2	8.4	17.4	19.0	20.0	18.0
Stock of loans of non-fin.private sector, % p.a.	0.7	5.1	3.3	4.8	.	.	.
Non-performing loans (NPL), in %, eop	0.8	0.5	0.5	0.4	.	.	.
Central bank policy rate, % p.a., eop 3)	0.00	0.00	0.00	0.00	.	.	.
Current account, EUR m	546	238	553	-239	-270	50	380
Current account, % of GDP	2.3	0.9	2.0	-0.9	-1.0	0.2	1.2
Exports of goods, BOP, EUR m	11,964	12,592	13,316	13,297	13,750	14,400	14,900
annual change in %	6.5	5.2	5.8	-0.1	3.4	4.7	3.5
Imports of goods, BOP, EUR m	12,873	13,816	14,207	13,459	14,500	15,200	15,500
annual change in %	6.8	7.3	2.8	-5.3	7.7	4.8	2.0
Exports of services, BOP, EUR m	6,082	6,633	7,180	5,594	6,200	6,700	7,100
annual change in %	10.3	9.1	8.3	-22.1	10.8	8.1	6.0
Imports of services, BOP, EUR m	4,229	4,739	5,161	5,442	5,500	5,600	5,900
annual change in %	8.1	12.1	8.9	5.4	1.1	1.8	5.4
FDI liabilities, EUR m	1,552	1,022	2,627	2,836	.	.	.
FDI assets, EUR m	613	-197	1,640	264	.	.	.
Gross reserves of CB excl. gold, EUR m	279	651	1,256	1,616	.	.	.
Gross external debt, EUR m	19,905	20,069	20,749	25,000	21,700	23,400	25,000
Gross external debt, % of GDP	83.4	77.4	73.8	92.0	78.0	80.0	80.0

1) Preliminary and wiiw estimates. - 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.