6. ESTONIA

On a path of rapid adjustment

Convergence of recent years sharply reversed in the current downturn...

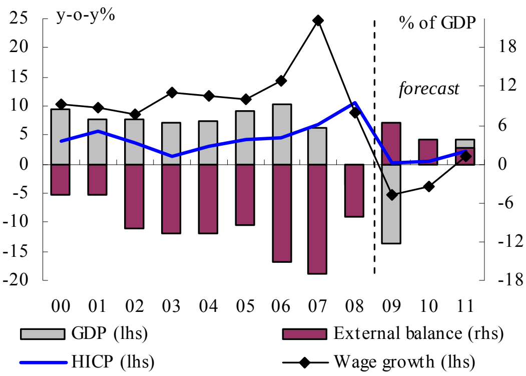
Estonia's years of rapid catching up, with growth at 8½% on average between 2000 and 2007, gave way in 2008-9 to the deepest economic contraction since the country's independence. Sizeable imbalances accumulated during the years of high growth, ultimately leading to a reversal of the cycle, which started with a contraction in domestic demand. Quarterly growth rates turned negative in early 2008 and, as the global loss of confidence in the second half of the year depressed external demand, the contraction in economic activity accelerated, reaching 3.6% in the year as a whole. The initially slow unravelling of accumulated imbalances reflected high price and wage inflation and a subdued labour market response.

Significantly over-optimistic official growth assumptions, coupled with a sharp fall in revenue, resulted in a distinctly expansionary fiscal stance in 2008, which helped counter the worsening cyclical conditions. Despite the adoption of a restrictive supplementary budget in mid-2008, the headline deficit reached 2.7% of GDP, following six years of nominal surpluses.

The contraction continued in 2009 and the economy had shrunk by almost a fifth by mid-year compared to the high point of the cycle in 2007. This was notably a reflection of the continued contraction in domestic demand, which had shrunk by 30% in the second quarter of the year compared to the same period of 2008. This was, in particular, due to a decline in fixed investment and de-stocking, and a smaller but still sizeable fall in private consumption. Although contributing to the contraction to a lesser extent than domestic components, external demand also continued to act as a drag on the economy. Across sectors, the most pronounced decline was registered in construction and financial intermediation – formerly the backbone of high growth rates – and in manufacturing. The decline in domestic demand was mirrored in the pronounced fall in imports.

Although there are some indications that the economy may have bottomed out during the summer months, there are no immediate prospects for quick recovery. Thus, even with a stabilisation in the last few months of the year, the overall output contraction is expected to approach 14% for 2009 as a whole.

Graph II.6.1: **Estonia - GDP, external balance, inflation and wage growth**



...but ongoing adjustment of the economy in 2009 narrows imbalances

In the context of Estonia's fixed exchange rate regime, the adjustment of the economy to correct the imbalances accumulated over the past years is largely taking place through the labour market and in prices.

After initial inertia – partly explained by the almost full employment achieved during the boom years – the adjustment in the labour market became very pronounced from the beginning of 2009, with employment falling by over 7% in the first quarter and almost 2% in the second. Unemployment increased significantly throughout the year, with the seasonal pattern being affected by changes to the labour law since the summer. Wage growth, which had contributed to the erosion of cost competitiveness in recent years, turned negative during the same period.

After the double-digit figures reached in spring 2008 (11.6%), HICP inflation converged quickly towards the euro area average and then turned negative in mid-2009, pulled down by a rapid fall in world commodity prices, the fading impact of earlier administrative price increases, as well as negative price pressure from weak domestic consumption. The latter's weakness also helped to limit the impact of a 2 pps. increase in the VAT rate, which took effect from mid-year, but was partly absorbed in mark-ups. Inflation is expected to remain low in the forecast period, given the still weak global economy and the low degree of capacity utilisation.

The severe contraction in internal demand contributed to a sudden retrenchment of imports, resulting in a sharp move from the high current account deficits recorded until 2008 to surpluses in the first half of 2009. The main adjustment took place through a narrowing of the merchandise trade deficit and diminishing profits in companies with foreign ownership (reducing the net income deficit), while services continued to perform rather well during the downturn and transfer receipts related to EU structural funds grew further.

Public sector also contributes to the rebalancing of the economy

Given the need to correct significant external and internal imbalances, the Estonian authorities implemented an ambitious fiscal consolidation in 2009. Their task became increasingly more challenging, however, as in the face of the worsening economic situation the government implemented successive ambitious packages, amounting in total to over 8% of GDP.

The very significant consolidation effort put in place in 2009 was achieved through a mixture of permanent and temporary measures, both on the revenue and expenditure sides. In particular, the reduction of the public sector wage bill has contributed positively to the unravelling of imbalances in the economy, while scaling down planned pension increases and other changes to the pension law will also improve sustainability of public finances in the medium term. On the revenue side, measures include increases in indirect and labour taxes and higher dividends from state-owned companies. The deficits in 2008 and 2009 were largely financed by running down assets accumulated as a result of previous years' surpluses, so leading to an only modest increase in public debt.

The consolidation effort is expected to bring the general government deficit to 3% of GDP in 2009, although there are significant risks surrounding this forecast, related to the possibility of higher unemployment growth and lower tax revenue, as well as to meeting targets on expenditure and non-tax revenue. Hence, the possibility of a deficit above 3% in 2009 cannot be excluded. These downward risks should be seen against the potential for a faster recovery and the determination of the authorities to ensure compliance with the Treaty deficit criterion.

The fiscal consolidation implemented so far, coupled with the ongoing modernisation of the public service, are expected to restrain expenditure growth going forward. At the same time, tax revenue is expected to be sluggish over the forecast period, even taking into account already implemented and planned tax increases. As a result, in the absence of further steps in addition to those foreseen in the current draft budget, the deficit in 2010 is projected to increase to marginally above 3% and remain around 3% in 2011. In view of the risks and of the need to reduce the deficit in a sustainable way, improving expenditure controls and the efficiency of public spending, as well as identifying additional revenue sources, could help to strengthen the fiscal position over the forecast period. General government debt, while increasing, is set to remain low, reaching 13% of GDP in 2011.

Recovery likely to be slow and initially supported by exports

Although the decline in economic activity appears to have stabilised, there is little reason to expect a fast recovery. The preceding boom and subsequent bust have brought economic activity back to the levels of 2005 and have left the economy with a higher burden of external debt. Servicing this debt will be one of the factors weighing on the recovery of domestic demand in the medium term.

While a modest recovery is expected in the coming quarters, growth is set to remain flat in 2010, with growth for the year as a whole turning positive only in 2011. Private consumption is not likely to support the recovery before 2011, given growing unemployment and declining nominal wages, even though consumer confidence is gradually strengthening. Likewise, fixed investment is not expected to start recovering before 2011, when the need to upgrade existing capacity will stimulate equipment investment in particular. However, some earlier positive impact can be expected from a turn in the stock cycle, as the confidence of companies strengthens and new orders show a stronger upward trend, taking into account the massive de-stocking that took place throughout 2008 and 2009.

With domestic demand flat, a modest positive growth impulse is expected in 2010 from external demand, in line with the global recovery. While market shares are unlikely to rise in 2010, improving competitiveness could lead to some increase in Estonia's share in global trade from 2011 onwards.

Lower costs and higher productivity growth lead to improved competitiveness

The competitiveness of exporting enterprises has benefitted from increased financial support made available through state programmes – in particular through EU structural funds – and via the banking sector. Such firms' exporting capacity is further reinforced by decreasing costs, as wage adjustment is already taking place and is expected to continue for some time, given the very flexible labour market, recently strengthened by the modernised Labour Law. Higher productivity growth is also expected to boost competitiveness. Ongoing efforts to further raise labour skills are helping to strengthen human capital efficiency and support a shift to more sophisticated exports. The counterparts to the increased capital formation in the tradable sector – supporting higher productivity growth – include increased domestic saving and recovering inward investment. Here, the financial sector is expected to play a key role in providing and facilitating the necessary financing in the right sectors. Despite the deteriorating quality of loan portfolios, the banking sector remains stable and well capitalised.

Table II.6.1:

Main features of country forecast - ESTONIA

		2008		Annual percentage change						
	bn EEK	Curr. prices	% GDP	92-05	2006	2007	2008	2009	2010	2011
GDP		251.5	100.0	-	10.0	7.2	-3.6	-13.7	-0.1	4.2
Private consumption		140.6	55.9	-	12.9	9.0	-4.7	-16.7	-1.9	2.9
Public consumption		48.8	19.4	-	3.5	3.7	4.1	-2.8	-3.5	1.5
Gross fixed capital formation		73.7	29.3	-	18.6	9.0	-12.1	-32.8	-3.2	8.8
of which : equipment		29.6	11.8	-	27.2	10.1	-2.9	-25.0	-5.0	11.0
Exports (goods and services)		190.2	75.6	-	14.0	0.0	-0.7	-15.2	1.6	5.8
Imports (goods and services)		200.7	79.8	-	22.9	4.7	-8.7	-29.7	0.8	5.5
GNI (GDP deflator)		236.3	94.0	-	8.3	5.2	-2.6	-11.4	-0.8	2.4
Contribution to GDP growth :	Domestic demand			-	13.7	8.8	-6.1	-19.5	-2.4	3.8
	Stockbuilding			-	2.8	2.2	-5.7	-6.4	1.8	0.0
	Foreign balance			-	-8.4	-4.4	6.8	12.3	0.6	0.4
Employment				-2.2	5.6	0.8	0.2	-9.0	-2.5	1.6
Unemployment rate (a)				-	5.9	4.7	5.5	13.6	15.2	14.2
Compensation of employees/f.t.e.				-	14.1	24.8	10.1	-4.5	-2.7	1.4
Unit labour costs whole economy				-	9.6	17.3	14.3	0.7	-5.0	-1.2
Real unit labour costs				-	1.9	6.4	7.2	0.9	-2.0	-3.1
Savings rate of households (b)				-	-	-0.5	3.0	11.2	5.4	4.3
GDP deflator				-	7.6	10.2	6.7	-0.2	-3.1	1.9
Harmonised index of consumer prices				-	4.4	6.7	10.6	0.2	0.5	2.1
Terms of trade of goods				-	2.7	3.4	-0.7	-6.4	-4.6	-0.3
Trade balance (c)				-	-18.1	-17.8	-11.7	-3.5	-5.4	-5.5
Current account balance (c)				-	-17.0	-17.9	-9.1	3.9	1.3	-0.3
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				-	-15.0	-16.9	-8.2	6.3	3.7	2.4
General government balance (c)				-	2.3	2.6	-2.7	-3.0	-3.2	-3.0
Cyclically-adjusted budget balance (c)				-	-0.2	-0.7	-4.2	-0.1	-0.4	-1.3
Structural budget balance (c)				-	-1.1	-1.0	-4.4	-2.5	-2.4	-1.9
General government gross debt (c)				-	4.5	3.8	4.6	7.4	10.9	13.2

(a) Eurostat definition. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.
Note : Contributions to GDP growth may not add up due to statistical discrepancies.