

6. ESTONIA

Adjusting to face gloomier years

2008 outcome worse than expected

The slowdown that had already started in Estonia in 2007 as a natural reversal of the cycle was increasingly aggravated by the global financial crisis. Domestic demand fell throughout 2008, with the year-on-year contraction reaching almost 15% in the last quarter. In addition, a marked deterioration in global and regional trade at the end of the year hit Estonia hard due to the openness of the economy. Overall, the year-on-year contraction of output reached 9.7% in the fourth quarter, and 3.6% for the year as a whole. The previous high accumulation of inventories, reflecting in particular unfinished construction, turned into destocking in 2008. The contribution of domestic demand was highly negative at over 8 percentage points for the year as a whole, partly counterbalanced by a positive impact from falling imports.

The slowdown and later contraction initially mostly affected those sectors that over-expanded during the boom years – retail and wholesale trade, real estate activities, construction and financial intermediation. However, by the end of the year the contraction became much more broadly based and also considerably affected the manufacturing sector and transport.

After a slow initial reaction, labour market deterioration gathered pace in late 2008. However, rapidly rising unemployment partly reflected second wage earners moving from inactivity to unemployment. Nominal wage growth eased considerably in the economy as a whole and in the private sector in particular. Slowing credit growth

throughout 2008 also contributed to declining domestic demand. By the end of the year, the deleveraging of the economy resulted in the monthly growth in credit to the private sector turning negative.

Contraction expected to continue

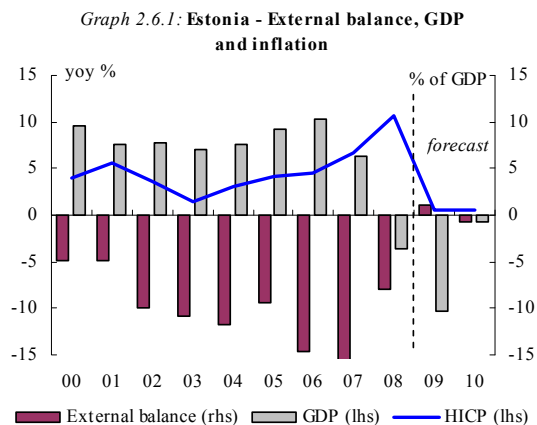
The economy is expected to contract considerably in 2009, by around 10%, and slightly further in 2010. Most confidence indicators remain at historically low levels, pointing to weak external and domestic demand, low capacity utilisation and pessimistic expectations. Private demand will continue to fall, due to low confidence, sharp adjustment on the labour market on the side of both employment and wages, as well as due to repayments of the debt accumulated by households during the years of high credit growth. Falling real-estate prices will also undermine private consumption. While private sector investments are expected to decline by around a quarter in 2009 and remain at low levels in 2010, a positive impact will come from the public sector investments.

The ongoing adjustment of the economy will free resources that can form the basis for further growth once the global and regional economic outlook improves. In particular, labour costs that are projected to turn negative from end-2009 will contribute to improving the competitive position of enterprises. However, a return to previous very high growth rates is unlikely over the medium term.

Imbalances unwinding rapidly

Labour market transition is expected to continue throughout the forecast period, with wage growth eventually turning negative to compensate for the losses seen in cost competitiveness over recent years. Unemployment is expected to accelerate further from the middle of 2009 onwards, when the new Labour Law, which aims at enhancing the flexibility of the labour market, enters into force. In 2010, unemployment is expected to reach 14%, a level comparable with the one prevailing in 2000 in the aftermath of the Russian crisis.

HICP headline inflation slowed substantially in the first months of 2009, due to lower world commodity prices and the fading impact of the



large excise tax increases of early and mid-2008; rapidly declining wage growth is dragging down core inflation. HICP inflation is expected to reach negative territory in the second half of 2009 and to broadly stabilise thereafter, remaining below 1% in both years. Core inflation is expected to continue to decline in 2010, as the wage decline progressively reinforces.

Similarly rapid adjustment is taking place with regards to external imbalances, as the current account deficit has halved in 2008 compared to 2007 and is expected to reach an almost balanced position in 2009, with EU structural funds financing covering the remaining current-account deficit.

2009, followed by additional consolidation measures adopted in April, mitigate the risk of breaching the 3% threshold in 2009, while further contraction of the economy and the steep adjustment on the labour market put additional pressure on the public finances in 2010, on the basis of unchanged policy assumption.

High deficits will result in an increase in government debt, which is projected to approach 8% of GDP by the end of the forecast period, even assuming a gradual running-down of fiscal reserves that have been accumulated over the years of nominal surpluses.

Public finances under severe pressure

The contraction in the economy has already taken its toll on public finances, with a deficit of 3.0% of GDP in 2008 after six years of nominal surpluses. A steady deterioration in the economic outlook and a deflationary environment will cause tax revenues to contract further in 2009 and 2010. A positive impact on revenue, without considerably affecting the overall balance, is, however, expected from the intensified use of EU structural funds. The substantial expenditure cuts adopted in February

Table 2.6.1:

Main features of country forecast - ESTONIA

	2007		92-04	Annual percentage change					
	bn EEK	Curr. prices		% GDP	2005	2006	2007	2008	2009
GDP at previous year prices	238.9	100.0	-	9.2	10.4	6.3	-3.6	-10.3	-0.8
Private consumption	131.8	55.2	-	9.9	12.7	7.9	-3.8	-9.0	-1.3
Public consumption	41.2	17.2	-	1.9	1.8	3.9	4.4	-3.6	-2.4
Gross fixed capital formation	77.6	32.5	-	8.3	20.1	7.6	-8.1	-20.7	-1.2
of which : equipment	31.2	13.1	-	-	-	-	-9.0	-15.0	2.2
Exports (goods and services)	177.7	74.4	-	20.9	11.6	0.0	-1.1	-14.1	0.4
Imports (goods and services)	203.7	85.3	-	17.5	20.4	4.2	-7.9	-16.0	-0.5
GNI at previous year prices (GDP deflator)	220.2	92.2	-	10.3	8.7	3.5	-1.5	-6.6	-1.9
Contribution to GDP growth :									
Domestic demand			-	8.5	13.7	7.6	-5.0	-11.6	-1.5
Stockbuilding			-	1.0	1.4	0.7	-3.4	-0.9	0.0
Foreign balance			-	1.0	-8.3	-3.9	6.0	2.2	0.7
Employment			-2.5	1.8	5.6	0.4	0.2	-7.3	-3.3
Unemployment rate (a)			-	7.9	5.9	4.7	5.5	11.3	14.1
Compensation of employees/f.t.e.			-	11.0	14.0	26.5	14.7	0.7	-3.5
Unit labour costs whole economy			-	3.5	9.1	19.4	19.3	4.1	-5.9
Real unit labour costs			-	-1.7	1.9	9.0	10.7	4.1	-5.1
Savings rate of households (b)			-	-	-3.0	0.8	11.1	20.6	17.2
GDP deflator			-	5.3	7.0	9.6	7.8	-0.1	-0.8
Harmonised index of consumer prices			-	4.1	4.4	6.7	10.6	0.6	0.5
Terms of trade of goods			-	1.3	2.7	3.3	-0.8	2.1	-2.9
Trade balance (c)			-	-13.9	-18.3	-17.6	-11.9	-8.4	-9.6
Current account balance (c)			-	-10.1	-16.7	-18.3	-9.1	-1.1	-3.1
Net lending(+) or borrowing(-) vis-à-vis ROW (c)			-	-9.4	-14.7	-17.1	-8.0	1.0	-0.7
General government balance (c)			-	1.5	2.9	2.7	-3.0	-3.0	-3.9
Cyclically-adjusted budget balance (c)			-	0.2	0.2	-0.5	-4.0	-0.4	-0.7
Structural budget balance (c)			-	0.2	-0.7	-0.8	-4.1	-1.0	-1.9
General government gross debt (c)			-	4.5	4.3	3.5	4.8	6.8	7.8

(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.