3. ESTONIA

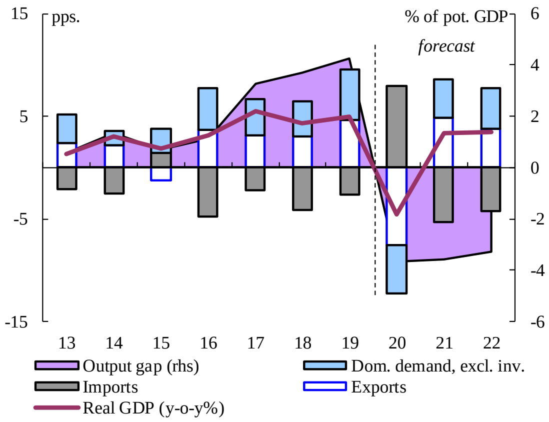
Estonia's GDP is forecast to drop significantly in 2020 but is set to recover and should return to its 2019 level by the end of 2022. The unemployment rate spiked in spring but has stabilised since then. Deflation in 2020 reflects significant falls in energy and tourism-related prices. Fiscal stimulus measures will extend into 2021 keeping the budget deficit at an elevated level although Estonia's public debt burden is forecast to remain the lowest in the EU.

2020: bad, but not as bad as expected

In the second quarter of 2020, GDP dropped by about 7% year-on-year. Private consumption and investment suffered the most, dropping 8% and 15% respectively. Still, the decline in economic activity was softened by sustained public expenditure and by a large reduction in imports. Imports had stalled due to the drop in investment in motor vehicles and machinery, but also due to the fall in fuel consumption. In the summer, when restrictions were removed, the economy recovered somewhat, with retail sales and exports rebounding to their 2019 levels. Investment resumed more cautiously. In terms of sectors, entertainment and tourism took the biggest hits, and losses are set to increase further due to travel restrictions reinstated in September. Economic activity has picked up in manufacturing and in ICT services, which has contributed strongly to service exports. While household and business sentiment have improved, they remain well below their long-term averages. Short-term indicators of economic activity point to a mild rebound in the third quarter and to a flattening afterwards. Overall, GDP is forecast to decline by 4½% in 2020.

In 2021, GDP is set to recover, expanding by 3½% primarily thanks to a rebound in private consumption and investment. Relatively high household savings, accumulated during the crisis, suggest that spending may resume once health-related constraints disappear. Investment is set to expand in 2021, supported by high public investment and the normalisation of private equipment investment after the extraordinary fall in 2020. This would contribute to an increase in imports and to a decline in the current account surplus to its pre-crisis level. The recovery of GDP is expected to continue in 2022 at a rate of 3½%, closely tied to the speed of recovery in the EU as a whole. It is assumed that consumer and business confidence will gradually normalise from 2021 onwards, following trends in Estonia's main export markets. Risks to the GDP projection are balanced. The downside risk of a deeper COVID pandemic is mitigated by the ability of the Estonian economy to recover quickly as was shown in the 2020 summer months. Furthermore, the forecast does not yet factor in the various support measures of the Next Generation EU (including the Recovery and Resilience Fund), which should raise growth prospects for the coming years.

Graph II.3.1: **Estonia - Real GDP growth and contributions, output gap**



Deflation reflects energy prices

Estonia saw some of the most significant deflation in the euro area in the first half of 2020, primarily due to a fall in fuel prices and in tourism-related services. Core inflation, excluding energy prices and unprocessed food, is still expected to be positive in 2020. The drop in fuel prices followed the fall in global commodity markets and was amplified by the temporary lowering of excise duties on diesel fuel from 1 May 2020 for two years. Headline inflation is forecast to average -0.5% in 2020 and to rebound afterwards to about 1.5% in 2021 and then over 2% in 2022, when the higher diesel excise will be reapplied.

Swift labour market reaction

Estonia's labour market has adjusted swiftly to the drop in demand, just as it did in recent recessions. Unemployment rose from 4.7% in the first quarter of the year to 7% in the second quarter. This was one of the fastest increases in the EU, even though employment was supported by a wage subsidy scheme, which extended into June and offered a subsequent two to three months shield from lay-offs. However, mirroring the recovery in economic activity, the rise in unemployment halted over the summer and even in September when the effects of the wage subsidy scheme had ceased. Still, with the end of the tourism season, some further rise in unemployment is expected over the coming months. On an annual basis, the unemployment rate is forecast to reach 7.5% in 2020 and almost 8% in 2021, before falling to below 7% in 2022. Given the decline in its working age population and specific labour shortages, wages are expected to grow, albeit rather unevenly across sectors. Wages are expected to increase most in the ICT sector, while wages in the hospitality and food services sector are expected to decline. Public sector wages are set to increase modestly.

Large fiscal stimulus in place for 2021

The general government deficit is expected to reach about 6% of GDP in 2020. The deficit is driven by both lower revenue (particularly from VAT, excises and corporate income tax) and the fiscal stimulus measures of about 3% of GDP (wage support scheme, healthcare expenditure, public investment, compensating local governments for revenue losses, temporary lowering of fuel excises). As a saving measure, state contributions to the second pillar pension funds were temporarily halted until 2022.

In 2021, the deficit is projected to remain at its 2020 level at around 6% of GDP. The 2021 budget foresees further expenditure rises, notably for a number of small-scale investment projects, an increase in pensions and spending for R&D, healthcare, defence and extension of COVID-19-related healthcare costs. In addition, the 2020 liquidity schemes (guarantees and loans) are assumed to impact the deficit by ¼% of GDP in 2021. Revenues are still impacted by the effects of the crisis.

Based on a no-policy-change assumption, the deficit is projected to decline to about 5% in 2022 linked to the wider recovery underway. Public debt is forecast to increase from 8.4% of GDP in 2019 to over 26% of GDP by 2022, which would still be the lowest in the EU.

Table II.3.1:

Main features of country forecast - ESTONIA

	2019			Annual percentage change						
	bn EUR Curr. prices	% GDP	01-16	2017	2018	2019	2020	2021	2022
GDP	28.1	100.0	3.4	5.5	4.4	5.0	**-4.6**	**3.4**	**3.5**
Private Consumption	13.8	49.0	4.2	2.9	4.6	3.3	**-4.4**	**3.5**	**3.9**
Public Consumption	5.6	19.9	2.5	1.1	0.7	3.0	**3.6**	**2.0**	**0.3**
Gross fixed capital formation	7.4	26.2	5.1	7.8	3.9	11.1	**-12.3**	**6.8**	**8.1**
of which: equipment	2.8	9.9	4.9	9.9	7.8	21.2	**-18.9**	**11.8**	**8.8**
Exports (goods and services)	20.5	72.9	7.0	4.1	4.0	6.2	**-10.4**	**7.3**	**5.5**
Imports (goods and services)	19.4	68.9	7.7	3.0	5.7	3.7	**-11.5**	**8.6**	**6.5**
GNI (GDP deflator)	27.5	97.7	3.5	5.3	4.8	4.7	**-4.4**	**3.3**	**3.4**
Contribution to GDP growth: Domestic demand			4.5	3.6	3.4	4.9	**-4.7**	**3.7**	**3.9**
Inventories			0.1	1.3	0.5	-0.6	**-0.3**	**0.1**	**0.0**
Net exports			-0.8	1.0	-1.1	2.0	**0.4**	**-0.4**	**-0.4**
Employment			0.4	2.7	1.2	1.3	**-3.5**	**0.2**	**1.7**
Unemployment rate (a)			9.4	5.8	5.4	4.4	**7.5**	**7.8**	**6.7**
Compensation of employees / head			8.0	10.5	9.0	9.3	**3.1**	**1.5**	**3.3**
Unit labour costs whole economy			4.9	7.6	5.7	5.4	**4.3**	**-1.6**	**1.6**
Real unit labour cost			0.2	4.3	1.5	2.1	**3.5**	**-2.9**	**-0.7**
Saving rate of households (b)			4.5	10.1	10.4	13.5	**18.5**	**17.0**	**16.1**
GDP deflator			4.7	3.1	4.2	3.2	**0.8**	**1.3**	**2.3**
Harmonised index of consumer prices			3.5	3.7	3.4	2.3	**-0.5**	**1.4**	**2.1**
Terms of trade goods			0.8	0.9	0.0	-0.7	**0.5**	**-0.1**	**-0.2**
Trade balance (goods) (c)			-10.2	-3.8	-4.7	-3.2	**-1.5**	**-2.7**	**-3.3**
Current-account balance (c)			-5.2	2.3	0.9	1.9	**2.8**	**2.0**	**1.2**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-3.4	3.2	2.2	3.1	**4.1**	**3.3**	**2.4**
General government balance (c)			0.5	-0.7	-0.5	0.1	**-5.9**	**-5.9**	**-5.1**
Cyclically-adjusted budget balance (d)			-0.5	-2.3	-2.3	-2.0	**-4.1**	**-4.1**	**-3.6**
Structural budget balance (d)			-	-2.3	-2.3	-2.0	**-4.1**	**-4.1**	**-3.6**
General government gross debt (c)			6.8	9.1	8.2	8.4	**17.2**	**22.5**	**26.4**

(a) as % of total labour force. (b) gross saving divided by adjusted gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.

Note : Contributions to GDP growth may not add up due to statistical discrepancies.