3. ESTONIA

Estonia entered the crisis from an economic peak, with a balanced economy and a solid financial sector. The deep recession this year sparked by the COVID-19 pandemic is expected to affect all sectors and lead to a sharp rise in unemployment. A large fiscal stimulus package will result in a large budget deficit but public debt should remain the lowest in the EU. The economy is set to rebound strongly in 2021 but activity levels are forecast to remain below 2019 levels.

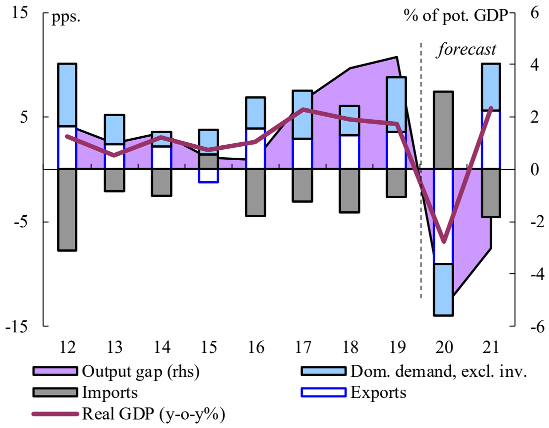
Growth momentum taken over by the crisis

After a strong 2019 in which GDP grew by 4.3%, Estonia's economy is forecast to contract by about 7% in 2020. COVID-19 has hit Estonia less severely than many other countries so fewer restrictions affecting the economy were introduced and industrial production and construction activity have been able to continue. Moreover, Estonia entered the crisis from a position of strength with record high employment, a current account in surplus, a solid financial sector and very low public debt. This has enabled the country to adopt quite a large fiscal stimulus package. Estonia also benefits from its well-developed IT sector and comprehensive e-government solutions, which have allowed public sector activities to continue relatively undisrupted while still respecting social distancing measures.

Short-term indicators suggest that economic momentum was still good in the first two months of 2020 before the crisis hit private consumption and economic confidence. Household purchasing power is being supported by the fiscal policy programmes in place, which should allow private consumption to recover once the crisis subsides. The decline in investment is set to be driven by a fall in corporate machinery investment. Construction is assumed to be affected with a lag, and should find some support from the increase in public investment. Exports and imports are projected to decline by over a tenth in 2020, with a large negative effect from the loss of tourism due to the strict closure of borders, initially even with closest neighbours.

As a small, open economy, Estonia's eventual recovery will be closely tied to the speed of recovery in the EU as a whole. The current forecast assumes a gradual normalisation in confidence along with the main export markets from the second half of 2020. Growth is expected to reach about 6% in 2021 once activity resumes in all sectors.

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



Price dynamics reflect energy prices

Headline inflation is forecast to fall from 2.3% in 2019 to well below 1% in 2020, rebounding to about 2% in 2021. Energy and service prices are expected to drop substantially, reflecting the trend in commodity prices, the cut in excise taxes and reduced demand. However, there is a risk that some prices could increase due to global transport and supply chain disruptions.

Swift labour market reaction

Compared to the financial crisis in 2008, a more tempered labour market adjustment pattern is expected in 2020, softened by policy measures, notably the introduction of a temporary wage subsidy. Unlike in 2008, public sector employment and wages are assumed to remain steady in 2020 as the current budget remains in force and budgetary constraints would kick in only in 2021. The short-term increase in unemployment will nevertheless be significant. Overall, the unemployment rate is projected to exceed 9% in 2020 (from 4.4% in 2019) before decreasing to 6½% in 2021, in line with the assumed rapid economic rebound and given the assumed agility of the labour market.

A large fiscal stimulus driving record deficit

Taking advantage of its very low public debt, the government adopted a relatively large stimulus package of over 4% of GDP. In addition, 3½% of GDP is made available for liquidity schemes. The stimulus measures appear primarily designed to support the existing economic structures, facilitating a faster economic recovery once the crisis abates. Apart from raising healthcare-related spending, the main measures include a temporary support to private sector liquidity (tax deferrals and guarantee provisions for investment), measures to sustain employment in all sectors of the economy and compensating local governments for revenue losses. Some specific investment programmes (housing insulation and road construction) support construction activity. Less conventional measures include lowering temporarily (for two years) excises for electricity, gas and diesel, for the time being helping the competitiveness of energy intensive industries and trucking. The support programme also foresees a temporary (for one year) halt of payments to second pillar pension funds. This will bring some savings to the budget in the short term, but in the longer term it will be compensated from the state budget for the pension savers. In addition to the planned stimulus, the economic shock would cut all revenue categories, bringing the general government deficit from 0.3% of GDP in 2019 to over 8% in 2020. Based on a no-policy-change assumption, the deficit is projected to decline to about 3½% in 2021, when the economy is expected to recover and most of the budgetary measures expire.

Public debt is forecast to jump from 8.4% of GDP in 2019 to over 22% of GDP by 2021, which would still be the lowest in the EU.

Table II.3.1:

Main features of country forecast - ESTONIA

		2018		Annual percentage change						
		bn EUR Curr. prices	% GDP	00-15	2016	2017	2018	2019	2020	2021
GDP		26.0	100.0	3.8	2.6	5.7	4.8	**4.3**	**-6.9**	**5.9**
Private Consumption		12.9	49.7	4.4	4.6	2.8	4.3	**3.1**	**-7.2**	**7.1**
Public Consumption		5.1	19.6	2.2	2.4	1.1	0.9	**2.9**	**4.3**	**-2.4**
Gross fixed capital formation		6.2	23.9	5.6	0.9	12.5	1.7	**13.2**	**-8.7**	**6.3**
of which: equipment		2.3	8.8	5.3	0.4	17.9	9.3	**12.9**	**-15.1**	**20.0**
Exports (goods and services)		19.3	74.3	6.2	5.1	3.8	4.3	**4.9**	**-12.5**	**8.5**
Imports (goods and services)		18.4	70.7	6.9	6.0	4.2	5.7	**3.7**	**-10.8**	**7.2**
GNI (GDP deflator)		25.5	98.1	3.8	2.6	5.6	5.3	**4.2**	**-6.8**	**6.0**
Contribution to GDP growth:	Domestic demand			4.7	3.0	4.6	2.7	**5.2**	**-4.9**	**4.4**
	Inventories			0.2	1.8	-0.2	0.9	**-0.2**	**-0.4**	**0.4**
	Net exports			-0.8	-0.5	-0.1	-0.8	**1.0**	**-1.6**	**1.1**
Employment				0.4	0.3	2.7	1.2	**1.3**	**-5.7**	**3.7**
Unemployment rate (a)				9.9	6.8	5.8	5.4	**4.4**	**9.2**	**6.5**
Compensation of employees / head				8.6	5.7	7.0	10.2	**7.8**	**2.0**	**2.7**
Unit labour costs whole economy				5.1	3.3	3.9	6.5	**4.6**	**3.4**	**0.6**
Real unit labour cost				0.3	1.6	0.2	1.9	**1.3**	**1.7**	**-1.3**
Saving rate of households (b)				5.0	9.8	10.0	11.2	**12.2**	**18.2**	**14.8**
GDP deflator				4.8	1.7	3.6	4.5	**3.2**	**1.7**	**2.0**
Harmonised index of consumer prices				3.7	0.8	3.7	3.4	**2.3**	**0.7**	**1.7**
Terms of trade goods				0.8	1.0	0.9	0.1	**-0.6**	**0.4**	**0.3**
Trade balance (goods) (c)				-11.0	-3.5	-3.5	-3.8	**-3.2**	**-2.8**	**-2.5**
Current-account balance (c)				-5.6	1.6	2.7	2.0	**2.3**	**1.1**	**2.2**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-3.8	2.6	3.6	3.4	**3.8**	**3.8**	**4.9**
General government balance (c)				0.5	-0.5	-0.8	-0.6	**-0.3**	**-8.3**	**-3.4**
Cyclically-adjusted budget balance (d)				-0.3	-0.7	-2.0	-2.4	**-2.4**	**-5.8**	**-1.9**
Structural budget balance (d)				-	-0.6	-2.0	-2.4	**-2.4**	**-5.8**	**-1.9**
General government gross debt (c)				6.5	10.2	9.3	8.4	**8.4**	**20.7**	**22.6**

(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.