3. ESTONIA

Following a moderate contraction in 2020, Estonia's GDP is forecast to increase by 9% in real terms in 2021, driven by private demand, government stimulus and buoyant exports. Growth is expected to remain strong in 2022-23 supported by a recovery in employment, sustained wage growth and dynamic foreign demand. Inflation is set to surge this year, fuelled by the transitory increases in imported energy prices gradually passing through to other goods and services. The government deficit is projected to narrow to 2.2% of GDP in 2023, with public debt remaining the lowest in the EU.

Growth rebounds strongly

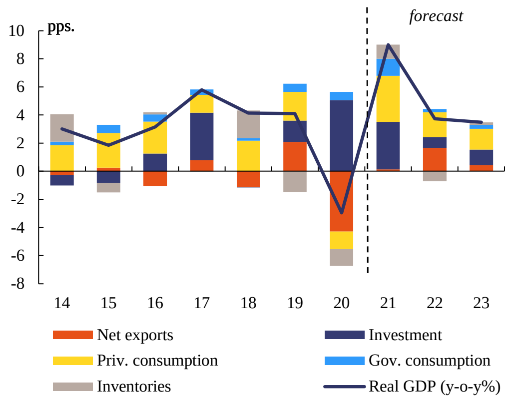
After dropping by 3% in 2020, real GDP is forecast to grow by 9% this year, driven by private consumption and investment. Output returned to its pre-crisis level in the first quarter of 2021. The expected sizeable increase in household consumption is driven by several factors: the removal of COVID-19 restrictions, some persisting fiscal support measures and the early withdrawal of assets from the second pillar of the pension system for a net amount of around 4% of GDP, about half of which are expected to lift consumption. Investment was pushed up in late 2020 and early 2021 by a single large foreign investment in intangible assets, likely to be one-off. Gross fixed capital formation is set to continue expanding at a vigorous pace this year.

Going forward, economic activity is forecast to return to more moderate, although still solid, growth rates of 3.7% in 2022 and 3.5% in 2023, with positive contributions in particular from private consumption and, in 2022, from net exports. Household consumption is expected to continue rising in 2022-23, thanks to brighter employment prospects and sustained wage increases. Investment growth is predicted to slow down in 2022 and pick up again in 2023, with faster rises in investment in equipment and non-residential construction, supported by the inflow of EU funds.

Stimulated by the swell in domestic demand, imports are forecast to rise substantially this year, compounding the escalation in energy prices. This is set to weigh on the trade balance, despite some projected gains in export shares, mainly of services. The rate of increase of both exports and imports is projected to remain robust in 2022-23, albeit going down to single-digit figures, on the back of a higher anticipated foreign demand for the goods and services that Estonia increasingly exports, particularly in the ICT sector.

Any possible further restrictions in Estonia or neighbouring countries linked to the COVID-19 pandemic represent a negative risk to short-term economic growth.

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



Imported inflation spreads to domestic sectors

Consumer price growth accelerated into the third quarter of 2021 and is estimated to remain elevated for the following three quarters. Annual HICP inflation is forecast at 4.0% this year, 3.9% in 2022, and 2.1% in 2023. The recent energy price hikes and global supply bottlenecks are bound to raise manufacturing, transport and delivery costs, affecting price developments in a significant portion of the economy, fading away only gradually. By 2023, labour shortages, notably for skilled labour, are expected to translate into wage pressures in various domestic sectors, pushing core inflation up.

Steady wage rise accompanies employment recovery

Labour losses that occurred at the beginning of the COVID-19 crisis started being reabsorbed in the last quarter of 2020. This early recovery stopped in the face of renewed restrictions, albeit mitigated by a new short-term unemployment benefit scheme, supported by the EU, launched in March 2021.

Employment is forecast to remain broadly stable throughout 2021 and expand gradually in 2022-23. The unemployment rate is estimated to remain at 6.8% this year and drop steadily afterwards, to 5.2% in 2023. Wage dynamics have been largely unaffected by the crisis, with repeated increases in 2020 and 2021, particularly in the government sector. Wage growth is expected to pick up in 2021 and accelerate thereafter, as the labour market becomes tighter. Combining the employment and wage projections, compensations per employee are set to soften until 2022 and then speed up in 2023. As a result, unit labour costs are forecast to start rising again next year, albeit at a moderate pace.

Narrowing government deficit

The general government deficit peaked at 5.6% of GDP last year. In 2021, it is projected to narrow to 3.1% of GDP, thanks to the economic recovery boosting tax receipts and the income tax revenue from the second pillar pension withdrawals, which amounts to about 1 percentage point of GDP. In addition, COVID-19 related worker- and business-support schemes in 2021 were taken up to a smaller degree than anticipated. At the same time, some spending increases introduced in 2020 and 2021 (pension increases, wages and investments) are of a more permanent nature and will remain in the expenditure base.

Following the expected better fiscal outcome this year, the 2022 budget foresees some new expenditure increases, principally for higher public wages, healthcare and additional investments. With the tax base continuing to recover and the remaining COVID-19 support measures due to expire, the deficit is projected to decrease to 2.5% of GDP in 2022 and 2.2% in 2023. The forecast also incorporates expenditures financed by RRF grants, which are set to gradually increase from 0.3% of GDP in 2021 to 0.8% of GDP in 2023.

Public debt is forecast to increase from 19% of GDP in 2020 to 21½% in 2023, still the lowest ratio in the EU. The government's large precautionary financing of 2020 is estimated to be only partially offset this year, when the debt ratio is estimated to fall slightly, also thanks to the strong nominal GDP growth. However, persistent budget deficits, less vigorous growth and some further asset accumulation are expected to drive the debt ratio up again in 2022 and 2023.

Table II.3.1:

Main features of country forecast - ESTONIA

	2020			Annual percentage change					
	bn EUR Curr. prices	% GDP	02-17	2018	2019	2020	2021	2022	2023
GDP	26.8	100.0	3.3	4.1	4.1	-3.0	**9.0**	**3.7**	**3.5**
Private Consumption	13.4	49.8	3.9	4.3	4.1	-2.5	**6.6**	**3.6**	**3.0**
Public Consumption	5.7	21.3	2.6	1.0	3.0	3.0	**5.7**	**1.1**	**1.3**
Gross fixed capital formation	8.2	30.7	5.1	0.0	6.1	19.9	**11.0**	**2.5**	**3.6**
of which: equipment	2.2	8.0	4.3	15.1	-4.9	-3.5	**6.7**	**5.0**	**4.6**
Exports (goods and services)	19.1	71.2	6.9	3.9	6.5	-5.0	**11.3**	**7.6**	**4.5**
Imports (goods and services)	19.0	70.7	7.1	5.7	3.8	0.9	**11.1**	**5.3**	**4.0**
GNI (GDP deflator)	26.4	98.5	3.5	4.5	3.8	-2.0	**9.2**	**3.7**	**3.3**
Contribution to GDP growth:	Domestic demand		4.4	2.4	4.1	4.4	**7.9**	**2.8**	**2.9**
	Inventories		0.0	2.0	-1.5	-1.2	**1.0**	**-0.7**	**0.2**
	Net exports		-0.5	-1.1	2.1	-4.3	**0.1**	**1.7**	**0.4**
Employment			0.5	0.9	1.3	-2.7	**0.2**	**1.4**	**0.6**
Unemployment rate (a)			8.9	5.4	4.4	6.8	**6.8**	**5.7**	**5.2**
Compensation of employees / head			8.0	8.6	8.4	5.3	**4.6**	**3.7**	**4.6**
Unit labour costs whole economy			5.1	5.2	5.5	5.5	**-3.9**	**1.4**	**1.7**
Real unit labour cost			0.6	1.2	2.2	5.8	**-6.6**	**-1.6**	**-0.8**
Saving rate of households (b)			5.1	12.3	12.7	15.6	**8.9**	**8.3**	**8.2**
GDP deflator			4.5	4.0	3.2	-0.3	**2.9**	**3.0**	**2.4**
Harmonised index of consumer prices			3.4	3.4	2.3	-0.6	**4.0**	**3.9**	**2.1**
Terms of trade goods			0.7	0.0	-0.7	1.1	**-1.1**	**-0.4**	**0.2**
Trade balance (goods) (c)			-9.5	-4.7	-3.4	-0.6	**-1.0**	**-0.4**	**0.0**
Current-account balance (c)			-4.6	0.8	2.0	-0.8	**-1.1**	**0.2**	**0.5**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-2.7	2.2	3.7	1.3	**0.4**	**1.6**	**1.8**
General government balance (c)			0.5	-0.6	0.1	-5.6	**-3.1**	**-2.5**	**-2.2**
Cyclically-adjusted budget balance (d)			0.3	-1.5	-0.7	-3.1	**-2.7**	**-2.2**	**-1.8**
Structural budget balance (d)			0.0	-1.5	-0.7	-3.1	**-3.7**	**-2.3**	**-1.8**
General government gross debt (c)			7.1	8.2	8.6	19.0	**18.4**	**20.4**	**21.4**

(a) Eurostat definition. (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.