3. ESTONIA

Real GDP growth is forecast to slow sharply to 1.0% this year, after 8.3% in 2021. The heightened uncertainty, commodity price increases and trade disruptions linked to Russia's invasion of Ukraine are holding back investment and trade flows, while private consumption is still set to increase, thanks to the savings buffer built over the past two years. The labour market is expected to integrate people fleeing from Ukraine only gradually, driving unemployment up. Inflation is forecast at double-digit rate in 2022, falling quickly to 2.5% in 2023. The government deficit is projected to rise from 2.4% of GDP in 2021 to 4.4% in 2022 and 3.7% in 2023, due to additional measures to address energy security and defence needs, supporting refugees and cushioning the social impact of price increases.

Growth prospects curtailed

Real GDP grew by 8.3% in 2021, but slowed sharply already at the beginning of this year, as consumers and investors adjusted to the surge in commodity and energy prices. Russia's invasion of Ukraine and the ensuing sanctions, have disrupted trade flows and pushed energy prices further up. This dampened the positive effect on consumption of removing the remaining COVID-19 related restrictions, as in this new context households spent only a small part of the extra savings accumulated during the pandemic and of the assets withdrawn from the second pillar pension funds.

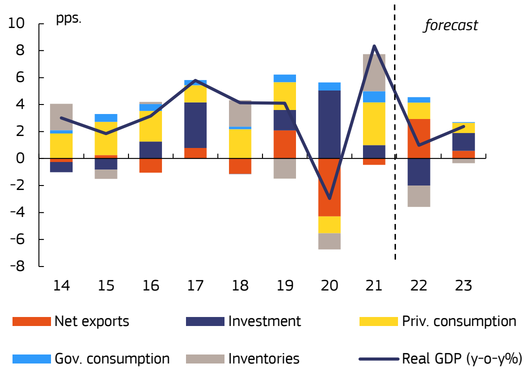
The uncertainties about the development of the war, together with renewed supply-chain tensions, weigh on investment decisions, in particular of foreigners. Part of the decrease in gross fixed capital formation is due to the unwinding of a significant investment in intangibles recorded at the turn of 2020-21, which determined similar fluctuations in the imports of services. As a result, real GDP is set to contract in the first half of the year and to rebound subsequently, averaging an annual growth rate of 1.0% in 2022 as a whole.

In 2023, Estonia is expected to diversify its import and export markets, further reducing its dependency on gas and other critical inputs imported from Russia and Belarus. Investment is forecast to bounce back in 2023, as supply bottlenecks subside and financial conditions remain favourable. EU funds inflows are expected to support construction and renewable energy projects. The push to accelerate the green transition, combined with the higher priority given to security and defence factors, are also set to boost investment.

Reduced imports of mineral fuels entail smaller exports of these or linked products, such as refined fuels and petrochemicals. Exports of higher value added goods and of information technology services are however forecast to pursue the robust expansion of recent years, allowing the current account to improve, despite this year's worsening terms of trade.

Estonia's economy appears to be adjusting rapidly to the rerouting of import and export flows, including of services such as tourism. However, it is still subject to the general risks of further disruption to the supply of key raw materials and faster increase of their price.

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



Wage growth falls behind inflation

The recovery in employment levels started much later than that in economic output, and is being further delayed in the current juncture. The inflow of people fleeing Ukraine is projected to add some 5,000 people to the labour force this year and 3,000 more in 2023. This is expected to temporarily add to unemployment, as these displaced persons find jobs more slowly than natives due to language and skills barriers. In turn, the additional labour force is expected to exert a certain drag on wages, which were rapidly rising in several sectors as the economy recovered fast from the COVID-19 crisis and some shortages of skilled workers emerged. Despite persistently tight labour market conditions in the expanding sectors, compensations per employee are forecast to increase by 7% in 2022, implying lower real wages, and by 4.5% in 2023.

Inflation to peak in early 2022, then to fall rapidly

HICP inflation increased quickly towards the end of 2021 and reached double-digit rates in January-April 2022. It is forecast to average 11.2% in 2022, as the soaring prices of imported energy and food affect consumer price dynamics.

The prices of imported energy and other commodities are, however, expected to stop increasing by mid-2022 and go back to pre-war levels by end-2023. Therefore, headline inflation is forecast to drop to 2.5% next year.

Additional government support increases deficit

The general government deficit improved to 2.4% of GDP in 2021 on the back of the economic recovery. At the same time, tax revenues were boosted by about 1% of GDP by the withdrawals from the second pillar pension funds.

In 2022, the deficit is projected to widen again to 4.4% of GDP, even though the COVID-19 expenditure measures have largely expired and tax revenues are expected to remain relatively buoyant thanks to strong growth of tax bases. The higher projected deficit largely reflects new spending on measures mitigating the impact of high energy prices, in security and defence, in integration of displaced persons and in other social measures, adding up to over 2% of GDP.

As some of these expenditure measures are set to be permanent (defence, social spending) and not offset by compensating measures, the deficit is projected to remain at a relatively elevated level of 3.7% of GDP in 2023. The forecast incorporates expenditure financed by RRF grants, which is set to gradually increase from 0.4% of GDP in 2022 to 0.7% in 2023.

Public debt is forecast to increase from 18.1% of GDP in 2021 to 23.5% in 2023, still the lowest ratio in the EU.

Table II.3.1:

Main features of country forecast - ESTONIA

		2021			Annual percentage change					
		bn EUR Curr. prices	% GDP	02-17	2018	2019	2020	2021	2022	2023
GDP		30.7	100.0	3.3	4.1	4.1	-3.0	**8.3**	**1.0**	**2.4**
Private Consumption		14.8	48.4	3.9	4.3	4.1	-2.5	**6.4**	**2.5**	**1.5**
Public Consumption		6.2	20.3	2.6	1.0	3.0	3.0	**3.9**	**2.0**	**0.3**
Gross fixed capital formation		8.8	28.6	5.1	0.0	6.1	19.9	**3.3**	**-7.0**	**5.0**
Exports (goods and services)		24.7	80.5	6.9	3.9	6.5	-5.0	**19.8**	**3.0**	**4.9**
Imports (goods and services)		24.6	80.3	7.1	5.7	3.8	0.9	**20.6**	**-0.6**	**4.3**
GNI (GDP deflator)		30.3	98.8	3.5	4.5	4.3	-2.0	**8.1**	**1.1**	**2.4**
Contribution to GDP growth:	Domestic demand			4.4	2.4	4.1	4.4	**5.0**	**-0.4**	**2.1**
	Inventories			0.0	2.0	-1.5	-1.2	**2.8**	**-1.6**	**-0.3**
	Net exports			-0.5	-1.1	2.1	-4.3	**-0.5**	**2.9**	**0.6**
Employment				0.5	0.9	1.3	-2.7	**0.1**	**0.7**	**1.0**
Unemployment rate (a)				8.9	5.4	4.5	6.9	**6.2**	**6.8**	**6.9**
Compensation of employees / head				8.0	8.6	8.4	5.3	**7.6**	**7.0**	**4.5**
Unit labour costs whole economy				5.1	5.2	5.5	5.5	**-0.6**	**6.7**	**3.0**
Saving rate of households (b)				5.1	12.3	12.7	16.4	**11.9**	**9.0**	**10.0**
GDP deflator				4.5	4.0	3.2	-0.3	**5.5**	**8.1**	**3.2**
Harmonised index of consumer prices				3.4	3.4	2.3	-0.6	**4.5**	**11.2**	**2.5**
Terms of trade goods				0.7	0.0	-0.7	1.1	**0.6**	**-2.2**	**1.0**
Trade balance (goods) (c)				-9.5	-4.7	-3.4	-0.6	**-4.4**	**-5.9**	**-5.2**
Current-account balance (c)				-4.6	0.8	2.5	-0.3	**-0.7**	**1.3**	**2.3**
General government balance (c)				0.5	-0.6	0.1	-5.6	**-2.4**	**-4.4**	**-3.7**
Structural budget balance (d)				0.0	-1.5	-0.8	-3.4	**-3.3**	**-3.8**	**-3.0**
General government gross debt (c)				7.1	8.2	8.6	19.0	**18.1**	**20.9**	**23.5**

(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.