RAHANDUSMINISTEERIUM

ECONOMIC FORECAST OF THE MINISTRY OF FINANCE OF ESTONIA SPRING 2017

Summary

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In past six months European sentiment indicators have exited from a narrow corridor, where they standed for last four years and indicate now clearly an increasing optimism. However, increased optimism has not passed through real economy and external assumptions for import demand from our main trading partners have been slightly downgraded when compared with 2016 Summer Forecast. This has resulted in a slightly lower economic growth expectations for 2017, while growth forecast for 2018 has been revised slightly upwards. Estonia's export growth in 2016 was a positive surprise, which suggests that rapid wage growth has not had a significant negative effect on competitiveness. Domestic demand growth in 2016 was lower than expected as long-waited increase in business investment activity did not materialise. Nevertheless, the more intensive use of EU funds, local elections and improving economic sentiment suggests that investments start to grow this year. The growth of private consumption has been strong, but this has been accompanied with an upward trend of households' savings rate, that is already at its historical high. However, the trend for savings rate could be reversed with restored inflation, which cuts real income growth significantly. General uncertainty remains high in the economy, but distribution of risks is more balanced than in 2016 Summer Forecast.
The assumptions of this forecast have been fixed at the start of March 2017.

1. MACROECONOMIC FORECAST

Estonia's gross domestic product is forecast to increase by 2.4% in 2017 and 3.1% in 2018. The main growth driver in 2017 is domestic demand which is based mainly on growth of investments. Imports will grow faster than exports this year and the contribution of net exports remains negative. Export growth will pick up in line with external demand gaining momentum in the coming years. In addition to exports, increase in domestic demand will support GDP growth, although its pace is forecast to moderate. In 2019-2021 Estonia's economy is forecast to grow by 2.7% per annum, supported both by export and domestic demand.

Private consumption growth is expected to decelerate significantly in 2017, mostly because of strong pickup in consumer price inflation since the end of 2016, following a three year decline. Strong wage growth continues, but half of it will be eliminated by 3,3% inflation in 2017. Consequently, private consumption growth is forecast to decelerate to 2,2% in 2017, but to accelerate again in 2018 as a result of robust rise in income tax allowance, which increases the net wage up to 10% for a significant share of wage earners. As inflation moderates, consumption growth will reach 4% again in 2018. After that consumption growth will stay slightly below GDP growth, as no further reforms are planned to increase disposable income of households and faster growth may come only from the decrease of the savings rate.

Investment has been falling for the past four years, but this trend should turn in 2017 with support from all sectors. Households' investment in dwellings has been increasing for six years and this trend is forecast to continue with increasing support from mortgages. Governement investment should pick up through the use of EU structural funds and local elections in autumn, which induce additional investment by municipalities. Nonfinancial corporations have been running a financial surplus until the end of 2016, as their investment has been significantly lower than profits for several years. Nevertheless, pickup of economic activity in the end of the year and significant improvement of several business climate indicators in Estonia and our export partners suggests that economic sentiment is really improving. Large ship purchases in the beginning of 2017 gave a big contribution to business investment which raises investment growth up to 9% in 2017 and the achieved level will be maintained also in 2018, without additional growth. If the improvement in sentiment is sustainable, investment growth will stay close to 4% during the following years.

In 2017, the demand from our important trading partners will strengthen, supporting brisk growth of *goods and services exports* (3.7%). The growth of goods exports is broad based, only the outlook in electronics is weaker due to declining foreign orders. Services exports will remain strong as a result of increasing visits of foreign tourists and the increase in IT and other business services exports. Estonia's EU presidency is expected to have a positive impact in the second half of the year as well. In 2018, the strengthening of global economy is projected to continue, favouring the developments of our trading partners. Exports will increase slightly faster compared to foreign demand, reaching 3.9% in 2018 and 4.0% in 2019. Imports is forecast to increase 5.4% this year, exceeding growth rate of exports due to large ship purchases and the recovery of government investments. In mid-term, the growth rate of imports will be slightly faster compared to exports as a result of strengthening of investment activity.

After peaking in 2016 at the level of 2.7% of GDP, the surplus of *current account* will narrow to 1.3% of GDP this year. Increasing imports of capital goods together with one-off ship purchases and the recovery of profits of foreign owned companies will reduce the surplus this year.

Consumer price inflation (CPI) will pick up to 3.3% in 2017, which is the fastest of the last five years and is a result of different factors. This is mostly related to growing commodity prices of food and crude oil, but the impact of domestic factors and tax measures is expected to increase as well. Driven by higher fuel prices and partly by higher excise duty rates since February, energy prices will increase 7% this year. Growing food prices in world markets have started to pass through to local consumer prices to a larger extent. Indirect taxes will raise inflation by 0.9%, coming mostly from alcohol, tobacco and fuel excise increases. In addition to excise duty increases in the beginning of the year, robust light alcohol excise increase will come extra in July. Price increases of services will pick up due to fading out of temporary factors and the added impact from growing fuel prices. In 2018, inflation is forecast to slow down to 2.7% because of the decreasing impact from foreign factors. Increase of energy prices decelerates as crude oil price is projected to stabilise according to futures. Services inflation should quicken slightly and the impact of tax measures will be peaking next year, contributing 1% of CPI. Because of smaller impact from tax measures, inflation will slow down to 2.5% in 2019 and to 2.0% in the end of forecast horizon.

Labour market situation is tightening further and wage pressures continue despite low economic activity. In 2016, employment increased by 0.6%, while unemployment rate increased to 6.8% due to higer participation rate. Employment growth was stronger in domestic demand oriented activities. For 2017, a moderate 0.5% increase in employment is expected, in line with economic developments. Employment growth is expected to slow down to 0.2% in 2018 and to 0% in 2019 due to labour supply constraints. Latest changes in demography point to slightly more positive developments in working age population (age group 15-74), but the trend is still negative in longer-run. Net migration has been positive since 2015. The labor market participation has been positively affected by the rise in the retirement age for women to 63 years by 2016, and the gradual general retirement age rise to 65 years by 2026 continues this trend. In addition, labour market participation is affected positively by the Work Ability Reform that started in mid-2016. The reform increases unemployment rate as an immediate effect as the skills of people affected are not in line with the labour market needs; and positive effects via higher employment are expected to gradually increase in time.

Wage growth has remained strong despite low economic growth. According to the wage survey, average wage growth increased to 7.4% in 2016, up from 6% in 2015. This was partly due to significantly higher bonuses, but but wage growth picked up without bonuses, too, reaching 7.2%. However, tax office data showed that wage growth remained at 6% throughout the year. Wage growth was higher in sectors with wages lower than the average, as they are more affected by a 10% minimum wage increase. Wage growth is forecast to remain strong at 5.9% due to improving sentiment and increasing investment activity. A slowdown to 5% in 2018 is expected as labour tax cuts contain wage pressures. Wage cost share in value added is expected to stabilise at the current level due to continuous tightness in labour market. Real wage growth is expected to slow down to 2.5% this years due to recovered inflation and remains below 3% within the forecast horizon.

2. FISCAL FORECAST

In 2016, the general government *budgetary position* remained in a surplus, making up 0.3% of GDP i.e. 57 million euros according to the initial data of Statistics Estonia. All government levels were in surplus – the central government by 0.1% of GDP and local governments by 0.2% of GDP. Social security funds ended the year with the surplus of 7 million euros. The nominal deficit of 2017 is forecast to be 0.5% of GDP. The main sector causing the deficit is central government, but local governments are also forecast to remain in a deficit for the entire forecast period. The nominal deficit of the central government is mainly caused by State Real Estate Co due to large investments. Thanks to the Unemployment Insurance Fund, the social security funds continue to be in a surplus (0.1% of GDP in 2017-2021). In 2018, the general government’s budgetary deficit is expected to increase to 0.8% of GDP, due to government’s additional strategic investments amounting to 0.5% of GDP. In 2019, the general government’s budgetary deficit is expected to decrease to 0.7% of GDP. In the following years the budgetary position of general government improves gradually and reaches a surplus of 0.1% of GDP by 2021.

In 2017, the *tax burden* is forecast at 34.8% of GDP, which is 0.1 percentage points higher than in 2016. When compared with 2016, labour and consumption taxes grow slightly faster than GDP, while capital taxes remain at the same level. During 2018–2021 the tax changes will decrease labour taxation and increase consumption taxation, in total the tax burden stays in average at 35.7% level reaching 35.8% of GDP in 2021.

Estonia’s *general government debt* decreased in 2016 and amounted to 9.5% of GDP, without the effect of European Financial Stability Fund (EFSF) it constituted 7.3% of GDP. According to the forecast the debt is expected to decrease and amount to 9.4 % of GDP in 2017, while it is forecast to increase in the next two years, reaching 10.5 % of GDP by 2019. The debt will start to decrease thereafter as a result of improving budgetary position of general government, amounting to 9,4 % of GDP by the end of the forecast period.

Table 1. GDP forecast for 2017-2021 (per cent)

	2016	2017*	2018*	2019*	2020*	2021*
1. Growth of real GDP	1.6	2.4	3.1	2.8	2.7	2.7
1a. GDP in real terms (bln EUR)	17.7	18.2	18.7	19.3	19.8	20.3
2. Growth of nominal GDP	3.3	5.6	6.3	5.7	5.6	5.5
2a. GDP in nominal terms (bln EUR)	20.9	22.1	23.5	24.8	26.2	27.6
2b. GNI in nominal terms (bln EUR)	20.5	21.7	23.0	24.3	25.6	27.0
Components of real GDP						
3. Private consumption expenditure (incl. non-profit organisations)	4.0	2.2	4.0	2.5	2.2	2.4
4. Government final consumption expenditure	1.0	2.2	0.7	1.1	1.2	1.2
5. Gross fixed capital formation	-2.8	9.3	0.0	4.8	4.7	4.7
6. Changes in inventories (% of GDP)	1.8	1.4	1.3	1.2	1.3	1.2
7. Exports of goods and services	3.6	3.7	3.9	4.0	4.0	3.9
8. Imports of goods and services	4.9	5.4	3.0	4.2	4.2	4.0
Contributions to real GDP growth 1)						
9. Domestic demand (without inventories)	1.7	3.7	2.3	2.7	2.6	2.7
10. Changes in inventories	0.8	-0.2	0.0	0.0	0.1	0.0
11. External balance of goods and services	-0.8	-1.2	0.8	0.0	0.0	0.0
Value added growth						
12. Primary sector	-8.6	1.8	2.6	2.0	1.8	1.8
13. Industry	-0.9	2.8	4.1	3.8	3.6	3.6
14. Construction	-0.1	3.0	4.0	3.7	3.6	3.6
15. Other services	2.4	2.2	2.7	2.5	2.5	2.5

1) Contribution to GDP growth indicates the share of a specific field in the economic growth. It is calculated by multiplying the field's growth with its share in GDP. The sum of the fields' share makes up the economic growth (the reason for a little difference is a statistical error – the part of GDP that could not be divided between the fields).

Source: Ministry of Finance of Estonia, Statistics Estonia.

Table 2. Price forecast for 2017-2021 (per cent)

	2016	2017*	2018*	2019*	2020*	2021*
1. GDP deflator	1.7	3.2	3.0	2.8	2.8	2.7
2. Private consumption deflator	0.8	3.5	3.0	2.6	2.6	2.3
3. Harmonised consumer price index	0.8	3.4	2.9	2.6	2.6	2.1
3a. Consumer price index	0.1	3.3	2.7	2.5	2.5	2.0
4. Public consumption deflator	4.0	4.5	4.5	4.2	4.1	4.0
5. Investment deflator	-1.1	1.9	2.7	2.5	2.5	2.6
6. Export price deflator	0.1	2.1	1.9	2.0	2.0	2.0
7. Import price deflator	-0.9	2.0	1.9	2.0	2.0	2.0

Source: Ministry of Finance of Estonia, Statistics Estonia.

Table 3. Labour Market Forecast for 2017-2021 (15–74- year-old) (per cent)

	2016	2017*	2018*	2019*	2020*	2021*
1. Employment. thousands	644.6	647.5	649.0	649.5	649.4	650.2
1a. Growth of employment	0.6	0.5	0.2	0.1	0.0	0.1
1b. Growth of employment without Work Ability Reform		0.3	0.0	-0.2	-0.5	-0.5
2. Unemployment rate	6.8	7.8	8.9	9.5	9.6	9.6
2a. Unemployment rate without Work Ability Reform		6.8	6.7	6.5	6.3	6.2
3. Growth of labour productivity (per person)	1.0	1.9	2.9	2.7	2.8	2.6
4. Real growth of average monthly wage	7.2	2.5	2.3	2.9	2.7	3.0
4a. Average monthly wage (EUR)	1 144	1 211	1 272	1 340	1 411	1 482
4b. Nominal growth of average monthly wage	7.4	5.9	5.0	5.4	5.3	5.1

Source: Ministry of Finance of Estonia, Statistics Estonia.

Table 4. Balance of Payments Forecast for 2017-2021 (% of GDP)

	2016	2017*	2018*	2019*	2020*	2021*
1. Net lending/borrowing vis-à-vis the rest of the world	3.5	3.1	4.2	3.8	3.4	2.9
1a. Current account	2.7	1.3	1.9	1.6	1.4	1.2
2. Balance of goods and services	4.2	2.9	3.5	3.4	3.3	3.2
3. Balance of primary incomes and transfers	-1.5	-1.6	-1.6	-1.7	-1.9	-2.0
4. Capital account	0.9	1.8	2.3	2.1	2.0	1.7
5. Errors and omissions	-0.9					

Source: Ministry of Finance of Estonia, Bank of Estonia.

Table 5. General government budgetary position, debt and tax burden 2016-2021 (% of GDP)

	2016	2017*	2018*	2019*	2020*	2021*
Budgetary position						
1. General government	0.3	-0.5	-0.8	-0.7	-0.3	0.1
2. Central government	0.1	-0.5	-0.9	-0.7	-0.3	0.3
3. Other general government	0.2	-0.1	0.0	0.0	0.0	-0.2
social security funds	0.0	0.1	0.1	0.1	0.1	0.1
local governments	0.2	-0.2	-0.1	-0.2	-0.1	-0.3
Debt burden						
4. General government	**9.5**	**9.4**	**9.9**	**10.5**	**10.1**	**9.4**
5. Central government (incl. EFSF)	6.1	6.0	6.6	7.3	6.8	6.0
6. Local governments	3.4	3.4	3.3	3.3	3.2	3.3
Tax burden	**34.7**	**34.8**	**35.8**	**35.8**	**35.5**	**35.8**

*forecast.
Source: Ministry of Finance of Estonia, Statistics Estonia.

Table 6. Comparison of economic forecasts

	Real GDP growth, %			Nominal GDP growth, %		
	2017*	2018*	2019*	2017*	2018*	2019*
Ministry of Finance	**2.4**	**3.1**	**2.8**	**5.6**	**6.3**	**5.7**
European Commission	2.2	2.6	–	5.3**	5.6**	–
Bank of Estonia	2.6	3.0	2.9	4.6**	5.7**	5.5**
IMF	2.3	2.8	2.7	4.4	5.0	–
OECD	2.4	2.9	–	4.9	5.6	–
SEB	2.2	3.1	–	–	–	–
Swedbank	2.2	2.8	–	5.0	5.4	–
Nordea	2.5	2.9	–	–	–	–
Estonian Institute of Economic Research	2.3	–	–	–	–	–
Consensus Forecasts	2.2	2.8	–	–	–	–

	Consumer price index, %			General government budgetary position, % of GDP		
	2017*	2018*	2019*	2017*	2018*	2019*
Ministry of Finance	**3.3 (3.4*)**	**2.7 (2.9*)**	**2.5 (2.6*)**	**-0.4 (-0.5***)**	**-1.7 (-0.7***)**	**-1.1 (-0.3***)**
European Commission	2.8*	2.8*	–	-0.5	-0.2	–
Bank of Estonia	2.8 (2.9*)	2.4 (2.7*)	2.0 (2.3*)	-0.4	-0.4	-0.3
IMF	2.5*	2.4*	2.5*	0.3	-0.2	-0.3
OECD	2.3*	2.6*	–	-0.5	-0.1	–
SEB	2.8*	2.7*	–	–	–	–
Swedbank	3.2	2.6	–	-0.6	-0.4	–
Nordea	3.0	2.4	–	-0.7	-0.6	–
Estonian Institute of Economic Research	2.5	–	–	–	–	–
Consensus Forecasts	2.3	2.4	–	-0.2	-0.2	–

** Harmonised Consumer Price Index (HICP)*
*** Calculated on the basis of the forecast of GDP volume or summing the GDP real growth and deflator*
**** With planned measures.*

Sources:
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Nordea. Nordea Economic Outlook. March 2017. 28.03.2017.
Eastern Europe Consensus Forecasts. 20.02.2017.

Table 7. External assumptions

	Assumptions in MoF 2017 spring forecast							Difference with MoF 2016 summer forecast		Sources
	2006–2016 average	2016	2017*	2018*	2019*	2020*	2021*	2017*	2018*	
1. Euribor, 3 months (annual average)	1.5	-0.3	-0.3	-0.2	0.0	0.1	0.3	0.0	0.0	COM, ECB, MoF
2. Eurozone's long-term interest rate (annual average)	2.3	0.1	0.5	0.8	1.0	1.2	1.4	0.4	0.5	Eurostat, COM, MoF
3. USD/EUR exchange rate (annual average)	0.778	0.904	0.945	0.946	0.946	0.946	0.946	0.05	0.05	BoE, MoF
4. Eurozone HICP	1.5	0.2	1.8	1.5	1.6	1.8	1.9	0.5	-0.1	Eurostat, ECB, MoF
5. Crude oil price (Brent, USD/barrel)	82.2	43.7	55.8	56.0	55.2	55.2	55.8	7.6	4.9	EIA, NYMEX Brent futures
6. Crude oil price (Brent, EUR/barrel)	62.8	39.5	52.7	53.0	52.2	52.2	52.8	9.5	7.1	EIA, NYMEX Brent futures
7. EU28 GDP growth	1.1	1.9	1.8	1.8	1.7	1.7	1.7	0.1	0.0	Eurostat, CF, MoF
8. Export markets GDP growth (12 countries)	1.2	1.6	1.6	1.6	1.7	1.7	1.6	0.1	-0.1	Eurostat, CF, IMF, MoF
9. Export markets import growth (40 countries)	3.2	2.5	3.4	3.6	3.9	3.9	3.8	-0.1	-0.4	Eurostat,IMF, COM, MoF

Sources: Historical data was obtained from Eurostat, Bank of Estonia, the U.S. Energy Information Administration (EIA); forecasts are based on the European Commission (COM), Consensus Economics (CF), IMF and NYMEX Brent futures, if possible, which have been adjusted according to the most recent developments and the expert opinions of the Ministry of Finance.