RAHANDUSMINISTEERIUM

# ECONOMIC FORECAST OF THE MINISTRY OF FINANCE OF ESTONIA SUMMER 2015

## Summary

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Tallinn
Ministry of Finance of Estonia
2015

*Economic sentiment* in the EU has continued on an upward trend since spring, when the previous MoF forecast was published, therefore confirming that the recovery from the crisis has finally kept momentum. Nevertheless, in Estonia the decline in economic sentiment has been relatively widespread, with this Estonia diverts from our closest neighbours and from the general trends in the EU. Despite the positive signs of recovery in the EU, unemployment remains high (except in Germany), weighing on Europe – the ongoing recession in Europe has not ended according to expert opinion. Demand for Estonia's has been subdued due to worsened economic climate in our trade partners, in particular the continuing stagnation in Finland and deepening recession in Russia. Economic growth in recent years has been consumption-led and supported by strong wage income growth. Stable or even falling consumer prices due to falling energy and food prices have increased purchasing power of households. Labour market situation keeps improving, although this is partially due to statistical effect from employees' registry since mid-2014 that has reduced undeclared work. Wage growth deceleration has been smaller than decline in nominal GDP growth rate, which has resulted in falling profitability of companies. Investment activity of companies remains low due to low demand, declining sentiment and lingering excess production capacity. External assumptions of the forecast were fixed in the beginning of September.

# 1. MACROECONOMIC FORECAST

According to the main scenario Estonia's GDP will grow by 1.7% in 2015 and 2.6% in 2016. By 2017, we expect growth to pick up to 3.4%, after which the growth rate declines to around 3% due to the closure of output gap and reducing number of employees. The Ministry of Finance has cut GDP forecast of this year compared with spring forecast mainly due to weaker than expected growth of the main trading partners. Growth forecast for the following years has remained broadly unchanged. This year export is projected to fall by 0.5%, while the growth recovers in 2016 and is set to increase in the following years in line with developments in export markets. Domestic demand remains the main growth driver as private consumption is expected to be supported by recovering investments from 2016 onwards. In 2018-19 Estonia's economy is forecast to grow 3%, supported both by export and domestic demand.

*Domestic demand* growth in 2015 is mainly supported by private consumption, although its' contribution is expected to decline markedly. In 2015, wage income growth remains lower than a year ago as average wage growth slows down and the number of employed persons grows moderately. Reductions in the tax wedge on labour combined with deflating consumer prices result in robust real net income growth. Consumer sentiment has remained high due to positive labour market developments, although it might weaken again as fear for unemployment has increased during the year. In 2016, due to declining employment and resuming inflationary environment, real wage income growth is set to decelerate markedly. As a result of this, private consumption growth reduces from 5% in 2015 to 2.8% in 2016 and remains at that level in the following years.

Both public and corporate sectors contributed to falling *investment* volumes in 2014 and developments in the first half of this year show that investment growth is not expected to recur in 2015. While falling investment volumes in the energy sector were the main driver of investment, it is now much more widespread between activities. Public investment started to grow again in 2015, and it is expected to have a positive contribution to growth in coming years due to launching of the next EU programme period. Strong housing investment growth is forecast to continue in 2015 and the following years. In 2015 as a whole, investment is expected to contract by 2%, while at least 4% growth rate is foreseen in the following years due to considerable recovery in export markets.

Strengthening of the economic recovery in the euro-zone only partly compensates declining demand from the eastern market. Outlook for goods *export* in 2015 in the second half of the year is undermined by contracting new orders for communication equipment, which have a significant share in total export. Services export is not expected to grow this year as export of transport and travel services remains weak. In 2015 as a whole, export of goods and services is forecast to decline by 0.5%. Foreign demand is expected to rebound as of 2016 due to strengthening global growth and ending recession in Russia. Export growth is picking up in line with increasing foreign demand, reaching 3.5% in 2016 and stabilising around 5.5% at the end of the forecast horizon. Import of goods and services declines by 1.5% in 2015, while it is forecast to grow by 4% in 2016 due to recovering investment activity and increasing intermediate inputs for export.

*Current account* surplus is projected to increase to 2.4% of GDP in 2015 as a result of low investment activity and exceptional dividend distribution of foreign companies. In the following years current account surplus is forecast to decline somewhat because of rebounding investment and increasing profitability of foreign investors.

Due to low energy prices *consumer prices* are expected to decline by 0.3% in 2015. Recovery of inflation is expected at the end of the year as a result of low comparison base in 2014, when oil prices were falling rapidly and food prices were at its low. Increases of alcohol prices in early 2015 add inflationary pressures. Services prices are restrained by free higher education, which now covers all three years of bachelor's level higher education. In 2016 inflation is expected to rebound to 2.0% due to receding negative impact of foreign factors and increasing impact from domestic factors. Declines in motor fuel and electricity prices will fade while gas and heating prices for households continue falling. In 2017 inflation is forecast to pick up to 2.9% as a result of accelerating services price increases due to increasing wage growth and rising food and energy prices. In coming years the role of indirect tax increases is expected to grow, inflationary effect peaks in 2017 when tax increases add 0.9 percentage points to consumer price inflation.

*Labour market* situation is getting tighter and falling unemployment combined with declining working age population create excess wage pressures. Labour participation and employment rates are at their historical highs, therefore prospects for further employment increases are modest. In 2015 as a whole employment is still expected to grow, although this statistical effect is partially explained by compulsory registration of employees since July 2014, which in addition to tax office data is also picked up by other labour market data sources. Employment is forecast to increase by 1% in 2015, before it starts to decline up to 0.5% per annum. Labour market developments are strongly affected by Work Ability Reform, which starts in mid-2016 and helps people with partial work ability to return to the labour market. It is assumed that remained skills of the people, who are being activated by the reform, are not in line with the labour market needs and employers' capability to hire such people is low, resulting in increasing unemployment as of 2017. Positive effects from the Work Ability Reform via increased labour supply are expected to gradually increase in time. Wage growth has not sufficiently reacted to a slowdown in nominal GDP growth rates, resulting in increasing labour market imbalances and pushing companies' profitability below its normal level. Therefore some adjustment in wage growth is expected in 2016. As a result of recovered foreign demand, wage growth starts gradually increasing again in 2017. Cuts in labour taxes help to restore normal wage cost to GDP ratio.

**Table 1. GDP forecast for 2015-2019 (per cent)**

| | 2014 | 2015* | 2016* | 2017* | 2018* | 2019* |
|---|---|---|---|---|---|---|
| 1. Growth of real GDP | 2.9 | 1.7 | 2.6 | 3.4 | 3.2 | 3.0 |
| 1a. GDP in real terms (bln EUR) | 17.4 | 17.7 | 18.2 | 18.8 | 19.4 | 20.0 |
| 2. Growth of nominal GDP | 5.0 | 3.1 | 5.5 | 6.4 | 6.3 | 6.0 |
| 2a. GDP in nominal terms (bln EUR) | 20.0 | 20.6 | 21.7 | 23.1 | 24.6 | 26.0 |
| 2b. GNI in nominal terms (bln EUR) | 19.5 | 20.2 | 21.2 | 22.5 | 23.9 | 25.3 |
| **Components of real GDP** | | | | | | |
| 3. Private consumption expenditure (incl. non-profit organisations) | 3.3 | 5.0 | 2.8 | 2.7 | 3.0 | 2.9 |
| 4. Government final consumption expenditure | 3.0 | 1.4 | 1.5 | 1.7 | 1.7 | 1.7 |
| 5. Gross fixed capital formation | -3.1 | -2.0 | 4.0 | 4.7 | 4.2 | 4.5 |
| 6. Changes in inventories (% of GDP) | 2.7 | 1.1 | 1.2 | 1.4 | 1.5 | 1.5 |
| 7. Exports of goods and services | 1.8 | -0.5 | 3.5 | 5.0 | 5.5 | 5.5 |
| 8. Imports of goods and services | 1.4 | -1.5 | 4.0 | 5.1 | 5.7 | 5.8 |
| **Contributions to real GDP growth** [1)] | | | | | | |
| 9. Domestic demand (without inventories) | 1.5 | 2.4 | 2.8 | 2.9 | 3.0 | 3.0 |
| 10. Changes in inventories | 2.4 | -1.5 | 0.1 | 0.2 | 0.13 | 0.03 |
| 11. External balance of goods and services | 0.4 | 0.7 | -0.2 | 0.2 | 0.0 | -0.1 |
| **Value added growth** | | | | | | |
| 12. Primary sector | 5.1 | 14.0 | -10.2 | 3.8 | 1.6 | 1.8 |
| 13. Industry | 4.6 | -1.8 | 4.4 | 5.1 | 4.8 | 4.3 |
| 14. Construction | -4.2 | -3.7 | 1.0 | 4.8 | 4.3 | 3.8 |
| 15. Other services | 1.9 | 1.1 | 2.5 | 2.8 | 2.7 | 2.6 |

*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 2015-2019 (per cent)

| | 2014 | 2015* | 2016* | 2017* | 2018* | 2019* |
|---|---|---|---|---|---|---|
| 1. GDP deflator | 2.0 | 1.4 | 2.8 | 2.9 | 3.1 | 2.8 |
| 2. Private consumption deflator | 0.8 | 0.1 | 2.2 | 3.1 | 3.1 | 3.0 |
| 3. Harmonised consumer price index | 0.5 | 0.2 | 2.3 | 3.1 | 3.2 | 3.1 |
| 3a. Consumer price index | -0.1 | -0.3 | 2.0 | 2.9 | 3.0 | 2.9 |
| 4. Public consumption deflator | 4.2 | 3.5 | 3.9 | 4.4 | 4.4 | 4.0 |
| 5. Investment deflator | 0.8 | 3.3 | 2.3 | 2.3 | 2.2 | 2.2 |
| 6. Export price deflator | -0.3 | -1.1 | 0.6 | 1.5 | 1.9 | 2.0 |
| 7. Import price deflator | -1.4 | -1.2 | 0.4 | 1.6 | 1.9 | 2.0 |

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

### Table 3. Labour Market Forecast for 2015-2019 (15–74- year-old) (per cent)

| | 2014 | 2015* | 2016* | 2017* | 2018* | 2019* |
|---|---|---|---|---|---|---|
| 1. Employment. thousands | 624.8 | 631.2 | 627.5 | 625.4 | 622.8 | 621.5 |
| 1a. Growth of employment | 0.6 | 1.0 | -0.6 | -0.3 | -0.4 | -0.2 |
| 2. Unemployment rate | 7.4 | 6.5 | 6.3 | 7.2 | 8.4 | 9.4 |
| 3. Growth of labour productivity (per person) | 2.3 | 0.6 | 3.2 | 3.8 | 3.6 | 3.3 |
| 4. Real growth of average monthly wage | 5.7 | 5.0 | 2.4 | 2.4 | 3.0 | 2.9 |
| 4a. Average monthly wage (EUR) | 1 001 | 1 049 | 1 096 | 1 155 | 1 224 | 1 297 |
| 4b. Nominal growth of average monthly wage | 5.6 | 4.8 | 4.5 | 5.4 | 6.0 | 5.9 |

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

### Table 4. Balance of Payments Forecast for 2015-2019 (% of GDP)

| | 2014 | 2015* | 2016* | 2017* | 2018* | 2019* |
|---|---|---|---|---|---|---|
| 1. Net lending/borrowing vis-à-vis the rest of the world | 2.1 | 5.0 | 3.7 | 3.7 | 3.2 | 2.7 |
| 1a. Current account | 1.0 | 2.4 | 1.6 | 1.3 | 0.0 | 0.0 |
| 2. Balance of goods and services | 3.4 | 4.1 | 3.8 | 3.7 | 3.6 | 3.3 |
| 3. Balance of primary incomes and transfers | -2.4 | -1.7 | -2.3 | -2.4 | -2.5 | -2.7 |
| 4. Capital account | 1.1 | 2.6 | 2.2 | 2.4 | 2.2 | 2.1 |
| 5. Errors and omissions | - | | | | | |

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

## Table 5. Comparison of economic forecasts

| | Real GDP growth, % | | | Nominal GDP growth, % | | |
|---|---|---|---|---|---|---|
| | 2015* | 2016* | 2017* | 2015* | 2016* | 2017* |
| **Ministry of Finance** | **1,7** | **2,6** | **3,4** | **3,1** | **5,5** | **6,4** |
| European Commission | 2,3 | 2,9 | – | 4,0** | 5,8** | – |
| Bank of Estonia | 2,2 | 3,1 | 3,6 | 4,8** | 6,3** | 6,8** |
| IMF | 2,5 | 3,4 | 3,4 | 4,6 | 5,7 | 5,7 |
| OECD | 2,1 | 3,3 | – | 3,2 | 5,4 | – |
| SEB | 2,2 | 2,7 | 3,4 | – | – | – |
| Swedbank | 1,9 | 2,8 | 2,8 | 4,6** | 5,4** | 5,6** |
| Nordea | 2,0 | 3,0 | 3,2 | – | – | – |
| Consensus Forecasts | 1,9 | 2,9 | – | – | – | – |
| Estonian Institute of Economic Research | 2,0 | – | – | 5,1** | – | – |

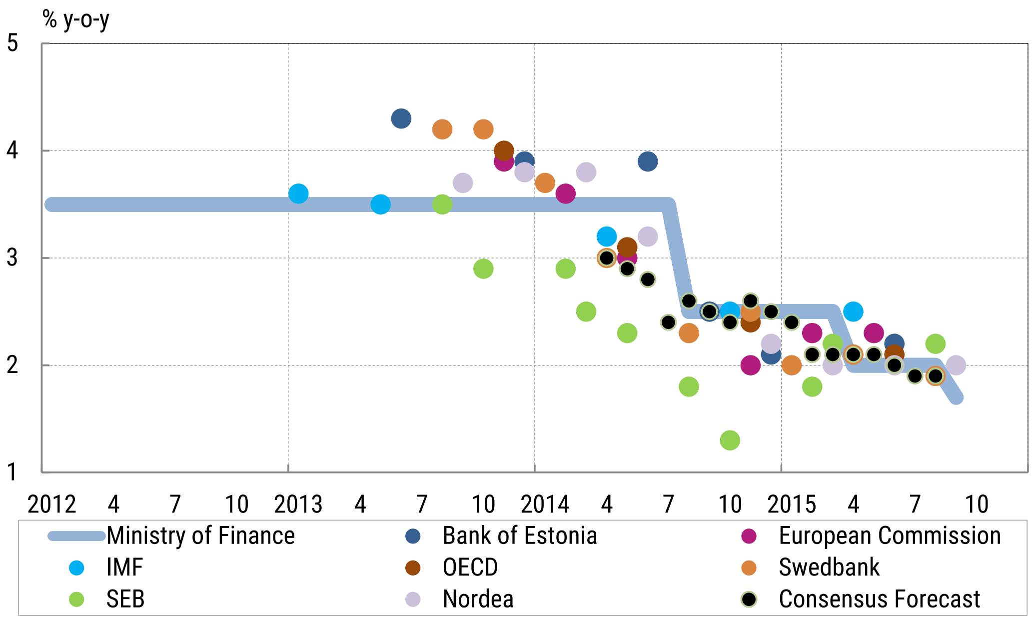
| | Consumer price index, % | | | General government budgetary position, % of GDP | | |
|---|---|---|---|---|---|---|
| | 2015* | 2016* | 2017* | 2015* | 2016* | 2017* |
| Ministry of Finance | **-0,3 (0,2*)** | **2,0 (2,3*)** | **2,9 (3,1*)** | **0,4** | **-0,2** | **0,1** |
| European Commission | 0,2* | 1,9* | – | -0,2 | -0,1 | – |
| Bank of Estonia | 0,0 (0,5*) | 2,6 (2,8*) | 2,7 (3,0*) | -0,1 | -0,1 | -0,2 |
| IMF | 0,4* | 1,7* | 2,0* | -0,6 | -0,2 | 0,0 |
| OECD | 0,1* | 1,8* | – | 0,4 | 0,6 | – |
| SEB | 0,4* | 2,3* | 2,7* | -0,7 | -0,5 | – |
| Swedbank | -0,2 | 1,9 | 2,5 | -0,5 | -0,2 | -0,1 |
| Nordea | -0,1 | 2,0 | 2,5 | -0,3 | -0,3 | -0,2 |
| Consensus Forecasts | 0,3* | 2,2* | – | – | – | – |
| Estonian Institute of Economic Research | 0,2 | – | – | – | – | – |

** Harmonised Consumer Price Index (HICP)*
*** Calculated on the basis of the forecast of GDP volume*

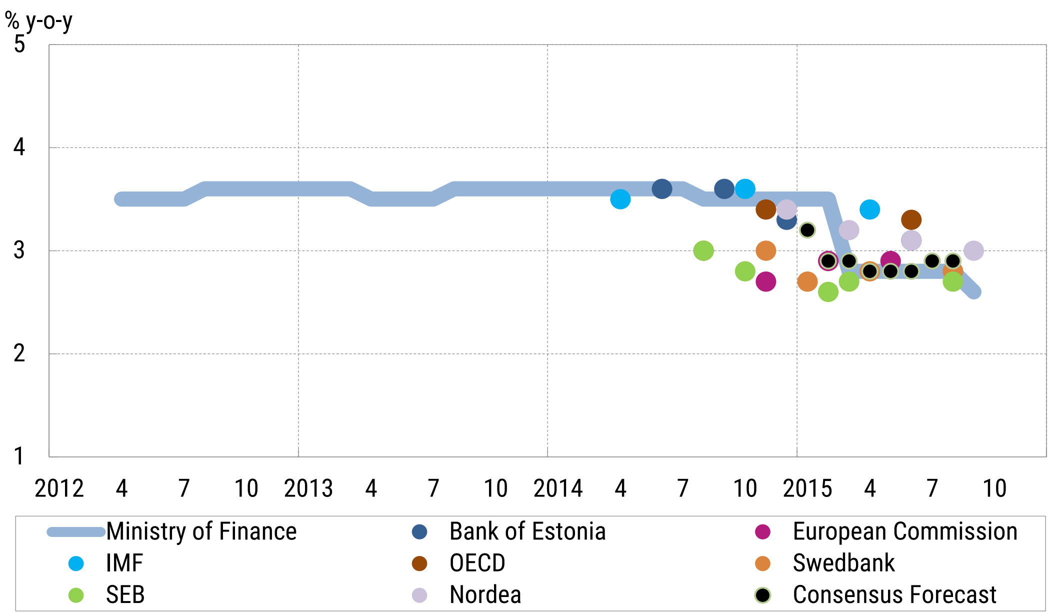
*Sources:*
*Ministry of Finance Economic Forecast. Summer 2015. 16/09/2015.*
*European Commission. European Economic Forecast. Spring 2015. 5.05.2015.*
*IMF. World Economic Outlook. April 2015. 15.04.2015.*
*OECD Economic Outlook. No 97. June 2015, 03.06.2015.*
*Bank of Estonia. Monetary policy and economy. 10/06/2015.*
*SEB. Nordic Outlook. August 2015. 25.08.2015.*
*Swedbank. Swedbank economic Outlook, August 2015. 24.08.2015.*
*Nordea. Economic Outlook. 02.09.2015.*
*Eastern Europe Consensus Forecasts. 17.08.2015.*

**Figure 1. Change in Estonia's economic growth forecasts (per cent)**

***A. Forecasts of Estonia's economic growth for 2015 according to forecast publication date***




***B. Forecasts of Estonia's economic growth for 2016 according to forecast publication date***




*Sources: Ministry of Finance, Bank of Estonia, European Commission, IMF, OECD, Swedbank, SEB, Nordea, Eastern Europe Consensus Forecasts.*

# 2. 2. FISCAL FORECAST

In 2015 general government *budgetary position* is in surplus by 0.4% of GDP. Most of the surplus comes from central government due to increased tax receipts, including unusual dividends from financial sector. Also social security funds will be in surplus during forecast period due to Unemployment Insurance Fund. In 2016 the central government budget will be in deficit as budget revenues growth is slower than costs growth. The deficit of State Real Estate Ltd increases as investments to real estate grow. General government budgetary position surplus is expected to increase to 1.4% of GDP in 2019 from 0.1% in 2017.

In 2015 the *tax burden* is forecasted to be at 33.5% of GDP which is 1.3 percentage points higher than in 2014. One of the reasons is unusual dividends from financial sector. In comparison with spring forecast the tax receipts were corrected upwards, at the same time nominal GDP was corrected downwards. It can be partly explained by the Tax and Customs board effective work, also in case of export oriented economy the slowing nominal GDP does not reflect entirely in tax receipts. During 2015–2019 the tax changes will decrease labour taxes and increase consumption taxes, in total tax burden stays during 2016-2019 close to 33% level reaching 33.0% of GDP in 2019.

The *general government debt* of Estonia in 2014 amounted to 10.4% of GDP, without European Financial Stability Fund (EFSF) it was 8.0% of GDP. Debt as % of GDP decreases every year reaching 7.6% of GDP by 2019.

At the end of 2014, *the general government liquid financial assets* (reserves) constituted 10.2% of GDP. Due to the state budget deficit and investments that need to be financed, the reserves are expected to decrease and comprise 8.5% of GDP by the end of 2016. Thereafter the amount of reserves will start to increase again, amounting to 8.8% of GDP by the end of 2019.

*Net debt of general government* comprised 0.2% of GDP in 2014. The net debt is forecasted to increase to 1.1% of GDP by the end of 2016, after that it will start to decrease and in 2019 reserves exceed debt by 1.2% GDP.

**Table 6. General government budgetary position, debt and tax burden 2014-2019 (% of GDP)**

| | 2014 | 2015* | 2016* | 2017* | 2018* | 2019* |
|---|---|---|---|---|---|---|
| **Budgetary position** | | | | | | |
| **1. General government** | **0.6** | **0.4** | **-0.2** | **0.1** | **0.8** | **1.4** |
| 2. Central government | 0.3 | 0.4 | -0.1 | 0.3 | 0.8 | 1.3 |
| 3. Other general government | 0.3 | 0.1 | 0.0 | -0.2 | 0.0 | 0.0 |
| social security funds | 0.3 | 0.1 | 0.1 | 0.2 | 0.2 | 0.2 |
| local governments | 0.0 | 0.0 | -0.2 | -0.3 | -0.1 | -0.2 |
| **Debt burden** | | | | | | |
| **4. General government** | **10.4** | **10.0** | **9.7** | **9.3** | **8.7** | **7.6** |
| 5. Central government (incl. EFSF) | 6.6 | 6.3 | 6.0 | 5.5 | 5.0 | 3.9 |
| 6. Local governments | 3.8 | 3.7 | 3.7 | 3.8 | 3.7 | 3.7 |
| **Tax burden** | **32.2** | **33.5** | **33.1** | **32.8** | **33.0** | **33.0** |

**forecast.*

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

**Table 7. Structural balance 2014-2019 (% of GDP)**

| | 2014 | 2015* | 2016* | 2017* | 2018* | 2019* |
|---|---|---|---|---|---|---|
| 1. Cyclically adjusted balance | 0.8 | 0.9 | 0.2 | 0.0 | 0.6 | 1.0 |
| 2. One-off measures | -0.2 | -0.5 | -0.3 | -0.3 | 0.0 | 0.0 |
| 3. **Structural balance** (3)=(1)-(2) | **1.1** | **1.4** | **0.5** | **0.3** | **0.6** | **1.0** |

**forecast.*

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