RAHANDUSMINISTEERIUM

ECONOMIC FORECAST OF THE MINISTRY OF FINANCE OF ESTONIA SUMMER 2016

Summary

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Tallinn
Ministry of Finance of Estonia
2016

MACROECONOMIC FORECAST

The external assumptions of the forecast were fixed in late August 2016.

Resulting from a continual weak sentiment in most of the sectors and deteriorating growth outlook, we have revised downwards economic forecast for Estonia. The main forecast scenario, which was based on recovering external environment, has not fully realised in past two quarters, and export growth remained narrow-based. Both experts and entrepreneurs do not foresee a considerable pick-up of economic growth in next six months. Nevertheless, Russia's recession has bottomed out and Finnish economy has managed to get out of the three year long stagnation, giving reason to expect higher external demand for Estonia. Investment activity has been subdued due to low external demand and deflation, both of which have depressed sales growth. In spite that private consumption growth remained strong in the light of sluggish GDP developments, households' saving rate has reached historical high. Labour market tensions have continued as wage growth has exceeded productivity developments in past four years. Inflation has remained very limited due to low commodity prices and is forecast to recur late this year only.

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According to the main scenario **Estonia's GDP** is forecast to grow by 1.3% in 2016. Economic growth is expected to pick up in the following years, reaching 2.5% in 2017 and 3% in 2018. The Ministry of Finance has revised downwards GDP forecast throughout the whole forecast horizon due to weaker growth outlook of the main trading partners. Domestic demand and private consumption in particular remains the main growth driver in 2016. Investment activity is expected to resume this year with increasing impact in the following years. Export is picking up, too, and from 2017 onwards follows export demand growth. In 2019-2020 Estonia's economy is forecast to grow by 2.7%, supported both by export and domestic demand.

Domestic demand is mostly supported by **private consumption** in 2016, which relies on continuous strong labour income growth. The purchasing power of households was also supported by decreasing prices during the first half of the year. Starting from the second half of the year, inflation picks up rapidly and starts to erode the real value of incomes. Raises in social transfers support significantly households' disposable income also during the following years. Although private consumption growth has been rapid compared with GDP growth in real terms during the past years, the saving rate of households has still been increasing, although already at a high level. Taking into account the generally uncertain situation in the economy and geopolitically, the saving rate is not expected to decrease significantly in the near future, as no good news are expected concerning different crisis. Private consumption growth is forecast to slow down to 3.3% in 2016 and 2.7% in 2017.

Investments have been falling for the past three years, but this trend should turn in 2016 with support from businesses and households. Two thirds of the investments is done by businesses, which means that the recovery is dependent on the improvement of the general economic environment, about which there is some hope related to improved export demand prospects. For the past five years, the economic sentiment has been flat without any positive or negative trend, which explains weak investment. Sales revenues have been decreasing or been very week also, partly because of energy price decreases and there has been enough spare capacity to meet the demand. Capacity utilization has been improving in some segments lately. Next year, the government sector should contribute significantly to investment growth, as the use of EU structural funds should finally start off. Investment growth should recover to about 1% in 2016 and accelerate with the help of the government sector to almost 7% in 2017, dropping back to 3–4% after that.

After a weak performance and decline of the **export** footprint last year, export of goods and services will turn to 2.7% growth in 2016. Growth will be driven by goods exports, being supported by the increase of export volumes of some commodity groups (electrical and communication equipment, articles of wood). Moreover, fluctuation of export orders of communication equipment is causing volatility between quarters. Export of services will strengthen as well as a result of increasing export income from travel services and business services. In 2017, gradual recovery of global growth outlook and thereby stronger economic growth and import demand of trading partners is expected. Growth of exports will pick up with a similar pace of foreign demand, reaching 3.5% in 2017 and 4.0% in 2018. Growth of imports will show faster growth rate compared to exports this year, as the investment activity, which has declined during the last three years, is expected to recover.

After peaking in 2015, the surplus of **current account** will narrow to 1.1% of GDP this year and remain at similar level in coming years as well. Increasing imports of capital goods and the recovery of profits of foreign owned companies will reduce the surplus this year. In forecast horizon the growth of export volumes is increasing, which will compensate the impact of stronger investment activity and altogether does not worsen the external balance.

The increase of **consumer prices** (CPI) will be low due to external factors, reaching 0.2% in 2016. In 2017, CPI growth is forecast to pick up to 2.7% and remain at the same rate in 2018 as well. While in the first half of this year declining energy prices were behind the deflation, then from the end of summer the negative contribution of energy prices will start to recede, causing the consumer prices to turn positive. Indirect taxes will raise the inflation by 0.8pp this year and the biggest contribution comes from alcohol and fuel excise duty increases. Without tax changes the prices are still declining. In 2017, inflation is expected to pick up as a result of the increase of external factors, higher services' inflation and additional excise duty increases. From external factors, the impact of declining oil prices will fade out and food prices will increase. Somewhat higher services inflation comes partly from the fading out of indirect effect of low oil prices and from fading out of free higher education as well. At the end of the forecast period CPI inflation will slow down slightly to 2.6% as a result of smaller tax impact.

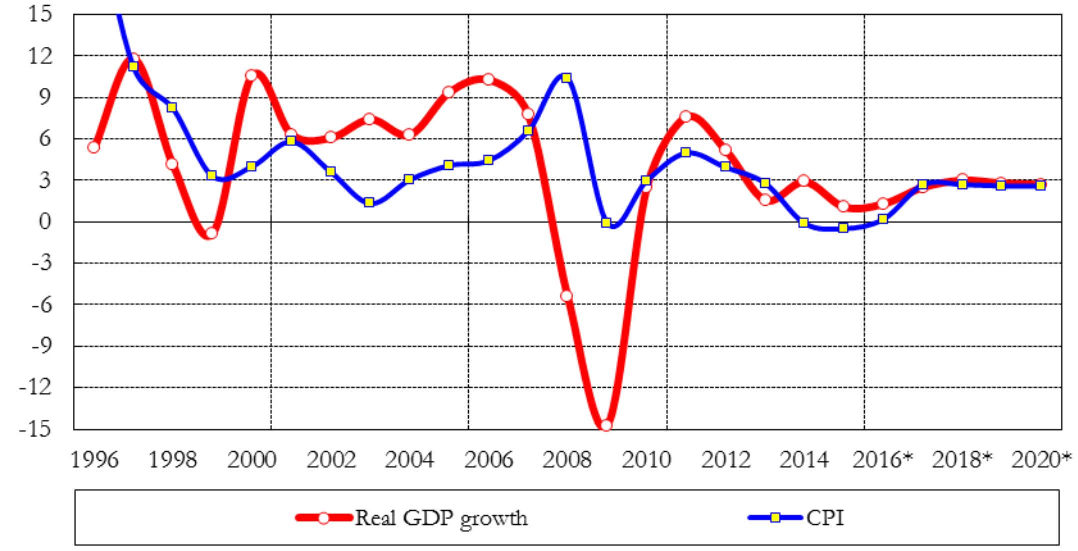
Labour market situation is tightening further and wage pressures continue. **Employment** has increased in spite of low economic activity, exceeding spring forecast expectations. The number of employed persons increased by 2.6% in the second quarter of this year and most of them were in the age group 50+. This is a result of increasing retirement age for women, but also due to generally higher activity rate of pension aged persons. Employment rate is at its historical high (65.8% in 2016), which in combination with declining working age population restrains further increase in the number of employed persons. The **unemployment** rate has remained at 2015 level due to higher activity rates, reaching 6.2% in 2016. Labour market developments are strongly affected by Work Ability Reform, which gradually started as of mid-2016. The reform helps people with partial work ability to return to the labour market. It is assumed that the 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 an 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 reacted sufficiently to a slowdown in nominal GDP growth, remaining at around 6% in the first half of 2016 according to the Tax Office. However, according to wage survey, average wage growth picked up to 7.8% in the first half-year. This was partly due to significantly higher bonuses, but wage growth picked up without bonuses, too, reaching 7.3%. Rapid wage growth has reduced profits, which is not sustainable. Nevertheless, companies' financial situation is still good despite falling profits as their financing needs are somewhat lower than usual due to low investment activity. Shrinking working age population and proximity of advanced economies, Finland in particular, results in continuing wage pressures. Therefore it is expected that labour share in value added stabilises at the current level, while there are some gains from labour tax cuts. Real wage growth is forecast to slow down from 6.2% in 2016 to below 3% in the following years.

Figure 1

Estonia's economic growth and the change of consumer price index

(per cent)

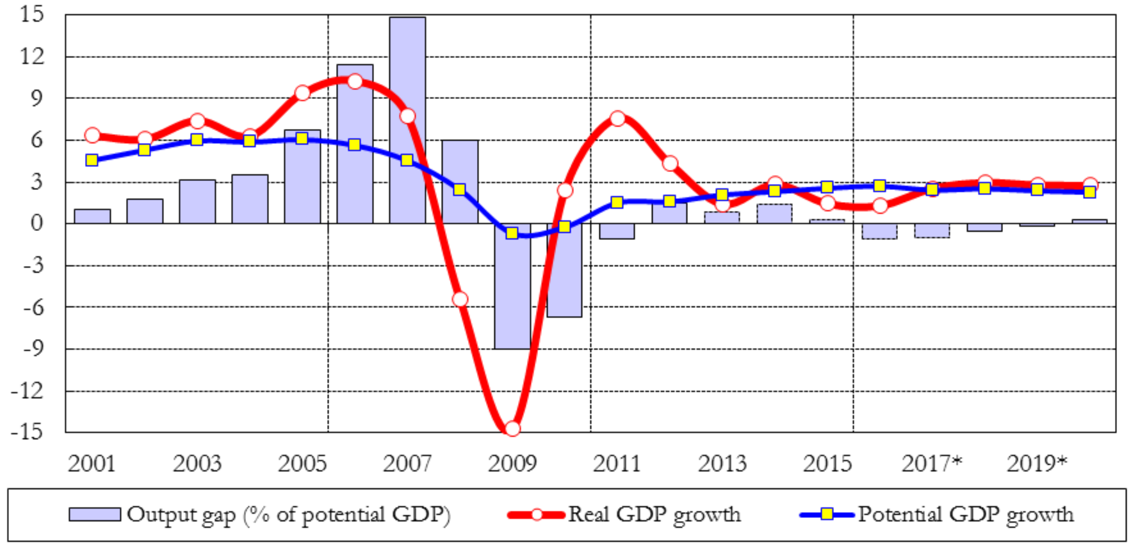


Source: Statistics Estonia, Ministry of Finance.

Figure 2

Development of potential GDP and output gap

(per cent)



Source: Statistics Estonia, Ministry of Finance.

Table 0.i) Basic assumptions

	2015	2016*	2017*
Short-term interest rate (annual average)	0,0	-0,3	-0,3
Long-term interest rate (annual average)	0,5	0,1	0,1
USD/€ exchange rate (annual average)	0,902	0,897	0,897
Nominal effective exchange rate	0,8	0,0	0,0
World excluding EU, GDP growth	3,2	3,2	3,6
EU GDP growth	2,0	1,8	1,7
Growth of relevant foreign markets	0,2	2,2	3,5
World import volumes, excluding EU	0,5	1,8	3,1
Oil prices (Brent, USD/barrel)	52,4	42,6	48,2

Source: Ministry of Finance.

Table 1.a. Macroeconomic prospects

	ESA code	2015	2015	2016*	2017*
		Level	rate of change	rate of change	rate of change
1. Real GDP	B1*g	17 472,0	1,4	1,3	2,5
of which					
1.1. Attributable to the estimated impact of aggregated budgetary measures on economic growth (1/)		–	–	–	–
2. Potential GDP			2,6	2,7	2,4
contributions:					
- labour			0,6	0,6	0,2
- capital			1,0	1,0	1,0
- total factor productivity			0,8	1,1	1,2
3. Nominal GDP	B1*g	20 251,7	2,5	3,1	5,2
Components of real GDP					
4. Private final consumption expenditure	P.3	9 343,9	4,6	3,3	2,7
5. Government final consumption expenditure	P.3	3 348,4	3,4	0,1	0,7
6. Gross fixed capital formation	P.51	4 085,6	-3,4	1,2	6,8
7. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	220,4	1,1	1,8	1,0
8. Exports of goods and services	P.6	15 066,9	-0,6	2,7	3,5
9. Imports of goods and services	P.7	14 678,6	-1,4	5,0	3,7
Contributions to real GDP growth					
10. Final domestic demand			2,3	2,1	3,2
11. Changes in inventories and net acquisition of valuables	P.52 + P.53		-1,6	0,7	-0,6
12. External balance of goods and services	B.11		0,6	-1,6	0,0

Source: Statistics Estonia, Ministry of Finance.

Table 1.b. Price developments

	ESA code	2015	2015	2016*	2017*
		level 2010=100	rate of change	rate of change	rate of change
1. GDP deflator		115,9	1,0	1,8	2,6
2. Private consumption deflator		113,5	0,0	0,7	2,8
3. HICP		113,7	0,1	0,9	2,9
4. Public consumption deflator		122,6	4,0	4,1	4,1
5. Investment deflator		117,3	2,9	-0,6	2,3
6. Export price deflator (goods and services)		106,6	-1,5	-0,1	1,3
7. Import price deflator (goods and services)		103,7	-1,8	-1,1	1,4

Source: Statistics Estonia, Ministry of Finance.

Table 1.c. Labour market developments

	ESA code	2015	2015	2016*	2017*
		Level	*rate of change*	*rate of change*	*rate of change*
1. Employment, persons		640,9	2,6	0,9	-0,1
2. Employment, hours worked					
3. Unemployment rate (%)		42,3	6,2	6,2	7,2
4. Labour productivity, (real GDP per employed person)		27 262	-1,1	0,4	2,6
5. Labour productivity, hours worked					
6. Compensation of employees	D.1	9 731,0	8,9	6,0	5,1
7. Compensation per employee		15 183	6,1	5,1	5,2

Source: Statistics Estonia, Ministry of Finance.

Table 1.d. Sectoral balances

	ESA code	2015	2016*	2017*
		% of GDP	*% of GDP*	*% of GDP*
1. Net lending/net borrowing vis-à-vis the rest of the world	B.9	4,3	2,9	3,4
of which:				
- balance on goods and services		4,2	3,2	3,0
- balance of primary incomes and secondary incomes		-1,9	-2,1	-2,2
- capital account		2,1	1,7	2,5
2. Net lending/net borrowing of the private sector	B.9			
3. Net lending/net borrowing of general government	B.9	0,1	0,3	-0,6
4. Statistical discrepancy		0,7	-	-

Source: Statistics Estonia, Ministry of Finance.

The economic forecast of the Ministry of Finance is prepared by analysts from the Fiscal Policy Department, who belong to personnel of the Ministry. The objectivity and independence of the forecast is assured through the transparency of forecast process, the involvement of different external economists and through continuous comparison of forecasting results. A preliminary version of the forecast will be discussed with the forecasting team of Bank of Estonia. Before finalisation of the forecast of the Ministry of Finance, its main assumptions and results will be discussed in a joint seminar with different forecasters in Estonia, who belong to the central bank, commercial banks and other institutions dealing with economic analysis. There are approximately ten institutions taking part from this seminar. In addition, different comparative tables and figures with the outcome of different independent forecasters can be found from the document of Ministry's economic forecast. On the basis of this it is easy to be convinced of systematical inducement by some forecasters.

Changes to the framework of co-ordination of economic and fiscal policies of EU Member States provide the creation of independent fiscal councils in all euro area member states, which monitor the accordance of fiscal policy to fiscal rules and assess the need to use the correction mechanisms implemented in the framework. Estonia's Fiscal Council, which is attached to the Central Bank, was established in 2014. According to the Treaty of the Fiscal Council, it must provide an assessment of government's economic and fiscal forecast, medium-term budgetary strategy and of achievement of the structural budget balance objective.

The opinion of the Fiscal Council on the summer 2016 economic forecast of the Ministry of Finance on 29.09.2016 says:[1]

- „ The summer 2016 forecast of the Ministry of Finance finds that GDP growth in Estonia in the short term will be lower than was earlier forecast, and that the economy will grow by 1.3% this year and 2.5% in 2017. Actual GDP and its potential level have been corrected downwards, and so has inflation. The Fiscal Council finds that this is in line with the changes that have occurred in the Estonian economic environment."
- „ The continuing rapid wage growth means that the updated fiscal forecast for tax receipts in the 2017 state budget is in fact better than it was in the spring. Unfortunately this will not lead to an improvement in the nominal budget position. The nominal general government deficit is 0.3 percentage point larger than in the state budget strategy for 2017–2020, and the structural surplus is 0.2 percentage point smaller. Although these differences are relatively small, increasing spending in the state budget for next year from what was in the spring budget strategy is not good practice. With domestic demand strong and tax receipts good, we find no justification for weakening the budget position."
- „ For this reason the Fiscal Council recommends that a state budget be passed that sets a target of a small structural surplus for 2017."

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In the following, there are pointed out most relevant differences between Ministry of Finance's 2016 summer forecast and other institutions latest public macroeconomic forecasts. Comparing them, one should keep in mind that forecasts are compiled in different periods and therefore based on different information, which causes variations in assumptions and results of the forecasts. As the foreign environment is uncertain and Statistical Office published revised GDP time series in September, then one should consider the assumptions of that time while estimating earlier forecasts.

During last months, economic growth expectations of the institutions for 2016 have been converged between 1.5-1.8%. Differences in the forecasts are partly resulting from the fact that if the forecast is

[1] More detailed analysis is found on the web page of the Fiscal Council: http://eelarvenoukogu.ee/files/Opinion%20Summer%20Forecast%202016.pdf

taking into account weaker than expected GDP growth in Q2 and the uncertainty regarding Brexit. Ministry of Finance's summer forecast for 2016 is the lowest, because it is also taking into account the GDP time series revision published in September. For 2017, institutions expect a pickup in economic growth driven by stronger foreign demand and the recovery of investments. Forecasts vary between 2.4- 3%. Ministry of Finance expects economic growth to pick up to 2.5%, which is at the lower end of the forecast range.

Table 1.e. Comparison of economic forecasts

	Real GDP growth, %			**Nominal GDP growth, %**		
	2016*	**2017***	**2018***	**2016***	**2017***	**2018***
Ministry of Finance	**1,3**	**2,5**	**3,0**	**3,1**	**5,2**	**5,8**
European Commission	1,9	2,4	–	3,6**	5,2**	–
Bank of Estonia	1,8	2,9	3,0	4,0**	5,3**	5,6**
IMF	1,5	2,5	2,9	2,8	3,8	4,7
OECD	1,8	3,0	–	2,6	4,8	–
SEB	1,7	2,4	3,0	–	–	–
Swedbank	1,5	2,5	2,7	3,9	5,0	5,4
Nordea	1,7	2,6	2,7	–	–	–
DNB	2,0	3,0	3,0	–	–	–
Consensus Forecasts	1,7	2,5	–	–	–	–
Estonian Institute of Economic Research	2,1	–	–	–	–	–

	Consumer price index, % (in brackets Harmonised Consumer Price Index)			**General government position, % of GDP**		
	2016*	**2017***	**2018***	**2016***	**2017***	**2018***
Ministry of Finance	**0,2 (0,9*)**	**2,7 (2,9*)**	**2,7 (2,9*)**	**0,1**	**0,3**	**-0,6**
European Commission	0,8*	2,9*	–	-0,1	-0,2	–
Bank of Estonia	0,0 (0,6*)	2,7 (2,9*)	2,2 (2,6*)	0,0	-0,1	-0,2
IMF	0,5*	1,4*	1,8*	0,2	0,2	0,1
OECD	0,4*	1,8*	–	-0,4	0,3	–
SEB	0,5*	2,4*	2,8*	–	–	–
Swedbank	-0,1	2,5	2,0	0,2	-0,2	-0,2
Nordea	0,2	2,6	2,3	0,0	-0,1	-0,2
DNB	0,6*	2,2*	2,5*	–	–	–
Consensus Forecasts	0,3	2,1	–	–	–	–
Estonian Institute of Economic Research	0,3	–	–	–	–	–

* Harmonised Consumer Price Index.
** calculated from the forecast of nominal GDP volume.

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