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MINISTEERIUM
MINISTRY of FINANCE of the REPUBLIC of ESTONIA

# Spring 2014 forecast
# Summary

Economic sentiment in the EU has been continually and rapidly improving since the last forecast of the Ministry of Finance published in August 2013. Clear improvement has taken place in industry, services and for consumers. However, the sentiment in construction is still low, which influences also Estonian construction services exports to Finland. Since the recovery in most Estonian export partners has been quite good already during the previous year, not much additional impact on Estonian export demand is expected from the improvements in recent EU averages. More broad recovery should still indirectly support the external environment of our partners.

The slightly rising trend of the Estonian economic sentiment index has been supported mostly by trade, services and consumers. The situation in industry has been stable, waiting for the pick-up in foreign demand. The situation in construction has nonetheless been worsening since the beginning of 2013 in relation to decreasing demand from the government sector and slowly improving demand from the private sector.

The foreign assumptions of this forecast were fixed in the middle of February 2014, before the escalation of events in Ukraine. Due to that the main scenario of the forecast does not take into account the impact of possible economic sanctions from EU against Russia and possible counteracting measures by Russia. The risk scenario, however, is based on the assumption that the Russian economy will decrease by 1% this year instead of growing by 2%, as in the main scenario, and corresponding impact from that to Finnish, Latvian, Lithuanian and Estonian economies. The future development of the geopolitical crisis is still related to very big uncertainty and in order to assess and quantify the short and long term economic impact would need some stabilization of the situation.

## 1. Macroeconomic forecast

The **gross domestic product** of Estonia will increase by 2.0% in 2014 and 3.5% in 2015. In 2016, 3.6% growth can be expected. Ministry of Finance has cut the GDP forecast for 2014 mainly due to weaker growth outlook of the main trading partners. Economic growth forecast for 2015 and 2016 has not been revised compared to autumn projection. GDP growth will pick up in the second half of this year as a result of the expected recovery of foreign demand. The driver of the economy will be domestic demand, however the contribution of exports will grow in 2014 as well. During 2015–2016, stronger economic growth can be expected in line with the strengthening of foreign demand.

The growth rates of **domestic demand** components will decrease slightly in 2014. Private consumption will still grow at a quite high pace of 3.9%, despite probable slowdown in the growth of the wage bill. This is supported by sharply slowing inflation in 2014 and income tax rate decrease in 2015. Thereafter the growth will moderate because of rising inflation and decrease of employment during the last years of the forecast. Investment growth will stay low like in 2013 – investment by companies is constrained by low demand for production and on the government side less financing from EU structural funds and $CO_2$ quota revenue. The level of housing investment by households is still very low, but the growth accelerated in the second half of 2013 and this trend should continue.

**Exports** of goods and services will grow by 2.4% in 2014. While in last years Estonia has been able to increase market share in its main export markets, then in this year export growth will be weaker compared to foreign demand. This is because of smaller orders from non-eurozone countries and the weakness in exports of major exporters. Foreign demand will start to pick up more intensely in 2015 and the growth opportunities of manufacturing companies will be expanded by a gradual recovery of Finnish economy as well. Growth of exports will accelerate at the similar pace like foreign demand, stabilizing in the end of the forecast horizon at around 6.5–7%. **Imports** of goods and services will grow by 3.3% in 2014 and during the next years will be somewhat faster compared to exports due to high investments needs of companies. However, negative contribution of net exports will decrease compared to previous years.

Foreign balance improved despite the weakness of export markets in 2013. **Current account** deficit narrowed to 1% of GDP as a result of smaller deficit of income account. In 2014, current account deficit will increase somewhat as a result of reserved export performance and stronger domestic demand. In the end of the forecast period current account deficit can reach 2% of GDP.

Consumer price **inflation** (CPI) will fall from 2.8% in 2013 to 1.4% in 2014 and pick up to 2.7% in 2015. Inflation will remain low in the first half of this year, accelerating since autumn because of growing food prices and higher core inflation. While during the last year's housing costs have been the main driver of inflation, then in 2014 housing costs will decline as a result of falling energy prices. Partly because of that, administrative price changes will have a negative contribution this year. According to crude oil futures, fuel prices will continue to fall. During forthcoming years, core inflation will pick up and energy prices will stabilize, resulting in higher headline inflation. If there will not be any large fluctuations in commodity prices, consumer prices will stabilize around 2.8% in the end of forecast period.

**Employment** growth decelerated in the end of last year and 0,2–0,3% growth should continue this year and in 2015, despite ongoing decrease of the working age population. There should still be some growth potential in the participation and employment rates, as the inactivity rate has been on a long and persistant declining trend. Employment will start to decrease starting 2016. Unemployment rate should fall close to 6% by the end of the forecast period, if the economic situation remains favourable. Average **wage** growth should slow down somewhat compared to the previous year, as the wage bill growth exceeded profits growth significantly in 2013. Increasing scarcity of labour should raise investment pressures if aggregate demand improves and this should enable average wage growth over 6% during the following years. Real wage growth should remain high (4.8%) in 20141, close to that of 2013, because of sharply declining inflation.

## Table 1. GDP forecast for 2013–2018 (per cent)

| | 2013 | 2014* | 2015* | 2016* | 2017* | 2018* |
|---|---|---|---|---|---|---|
| 1. Growth of real GDP | 0.8 | 2.0 | 3.5 | 3.6 | 3.4 | 3.2 |
| 1a. GDP in real terms (bln EUR) | 12.8 | 13.1 | 13.6 | 14.0 | 14.5 | 15.0 |
| 2. Growth of nominal GDP | 5.9 | 4.9 | 6.9 | 6.8 | 6.4 | 6.1 |
| 2a. GDP in nominal terms (bln EUR) | 18.4 | 19.3 | 20.7 | 22.1 | 23.5 | 24.9 |
| 2b. GNI in nominal terms (bln EUR) | 17.7 | 18.6 | 19.9 | 21.2 | 22.6 | 23.9 |
| **Components of real GDP** | | | | | | |
| 3. Private consumption expenditure (incl. non-profit organisations) | 4.2 | 3.9 | 3.8 | 3.3 | 3.2 | 3.1 |
| 4. Government final consumption expenditure | 1.3 | 1.0 | 1.0 | 1.0 | 1.0 | 1.0 |
| 5. Gross fixed capital formation | 1.0 | 0.7 | 3.7 | 5.3 | 7.4 | 5.7 |
| 6. Changes in inventories (% of GDP) | 1.6 | 1.8 | 2.3 | 2.8 | 2.6 | 2.4 |
| 7. Exports of goods and services | 1.8 | 2.4 | 6.0 | 6.5 | 6.7 | 6.7 |
| 8. Imports of goods and services | 2.6 | 3.3 | 6.3 | 6.6 | 7.1 | 7.0 |
| **Contributions to real GDP growth** 1) | | | | | | |
| 9. Domestic demand (without inventories) | 2.7 | 2.4 | 3.1 | 3.3 | 3.7 | 3.3 |
| 10. Changes in inventories | -1.2 | 0.3 | 0.5 | 0.3 | 0.0 | 0.1 |
| 11. Ext. balance of goods and services | -0.7 | -0.7 | -0.2 | -0.1 | -0.4 | -0.2 |
| **Value added growth** | | | | | | |
| 12. Primary sector | -3.5 | 4.0 | 2.2 | 2.3 | 2.1 | 2.0 |
| 13. Industry | 4.5 | 5.2 | 5.6 | 5.0 | 4.8 | 4.2 |
| 14. Construction | -5.7 | -5.1 | 3.9 | 4.7 | 4.3 | 4.0 |
| 15. Other services | 2.0 | 1.4 | 2.8 | 3.0 | 2.9 | 2.8 |

*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 2013–2018 (per cent)

| | 2013 | 2014* | 2015* | 2016* | 2017* | 2018* |
|---|---|---|---|---|---|---|
| 1. GDP deflator | 5.0 | 2.8 | 3.2 | 3.0 | 2.8 | 2.7 |
| 2. Private consumption deflator | 3.4 | 2.3 | 2.9 | 2.9 | 2.8 | 2.8 |
| 3. Harmonised consumer price index | 3.2 | 1.7 | 2.9 | 3.0 | 3.0 | 3.0 |
| 3a. Consumer price index | 2.8 | 1.4 | 2.7 | 2.8 | 2.8 | 2.8 |
| 4. Public consumption deflator | 6.1 | 4.5 | 5.0 | 4.5 | 4.5 | 4.5 |
| 5. Investment deflator | 5.0 | 3.0 | 2.3 | 2.1 | 2.2 | 2.1 |
| 6. Export price deflator | 1.0 | 0.8 | 1.7 | 2.0 | 2.0 | 2.0 |
| 7. Import price deflator | -0.4 | 0.8 | 1.6 | 2.0 | 1.9 | 1.9 |

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

### Table 3. Labour Market Forecast for 2013–2018 (15–74- year-old) (per cent)

| | 2013 | 2014* | 2015* | 2016* | 2017* | 2018* |
|---|---|---|---|---|---|---|
| 1. Employment. thousands | 621.4 | 622.5 | 624.5 | 624.0 | 622.0 | 619.0 |
| 1a. Growth of employment | 1.0 | 0.2 | 0.3 | -0.1 | -0.3 | -0.5 |
| 2. Unemployment rate | 8.6 | 7.9 | 6.9 | 6.4 | 6.0 | 6.0 |
| 3. Growth of labour productivity (per person) | -0.2 | 1.8 | 3.2 | 3.7 | 3.8 | 3.7 |
| 4. Real growth of average monthly wage | 4.9 | 4.8 | 3.5 | 3.5 | 3.6 | 3.7 |
| 4a. Average monthly wage (EUR) | 948 | 1007 | 1071 | 1139 | 1213 | 1293 |
| 4b. Nominal growth of average monthly wage | 7.8 | 6.2 | 6.3 | 6.4 | 6.5 | 6.6 |

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

## Table 4. Balance of Payments Forecast for 2013–2018 (% of GDP)

| | 2013 | 2014* | 2015* | 2016* | 2017* | 2018* |
|---|---|---|---|---|---|---|
| 1. Net lending/borrowing vis-à-vis the rest of the world | 1.7 | 1.3 | 1.2 | 0.7 | 0.5 | 0.5 |
| 1a. Current account | -1.0 | -1.6 | -1.7 | -1.9 | -2.1 | -2.2 |
| 2. Balance of goods and services | 2.0 | 1.2 | 1.1 | 1.0 | 0.7 | 0.6 |
| 3. Balance of primary incomes and transfers | -3.0 | -2.8 | -2.8 | -2.9 | -2.8 | -2.8 |
| 4. Capital account | 2.7 | 2.9 | 2.9 | 2.6 | 2.6 | 2.7 |
| 5. Errors and omissions | 1.2 | | | | | |

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

## Table 5. Comparison of economic forecasts

| | Real GDP growth, % | | | Nominal GDP growth, % | | |
|---|---|---|---|---|---|---|
| | 2014* | 2015* | 2016* | 2014* | 2015* | 2016* |
| **Ministry of Finance** | **2.0** | **3.5** | **3.6** | **4.9** | **6.9** | **6.8** |
| European Commission | 2.3 | 3.6 | – | 5.3 | 7.1 | – |
| Bank of Estonia | 2.6 | 3.9 | – | 5.8 | 7.9 | – |
| IMF | 2.5 | – | – | – | – | – |
| OECD | 2.4 | 4.0 | – | 5.0 | 7.2 | – |
| SEB | 0.5 | 2.5 | – | – | – | – |
| Swedbank | 3.0 | 3.7 | – | 6.0** | 7.0** | – |
| Nordea | 2.8 | 3.8 | – | 5.0** | 8.0** | – |
| Estonian Institute of Economic Research | 3.0 | – | – | – | – | – |

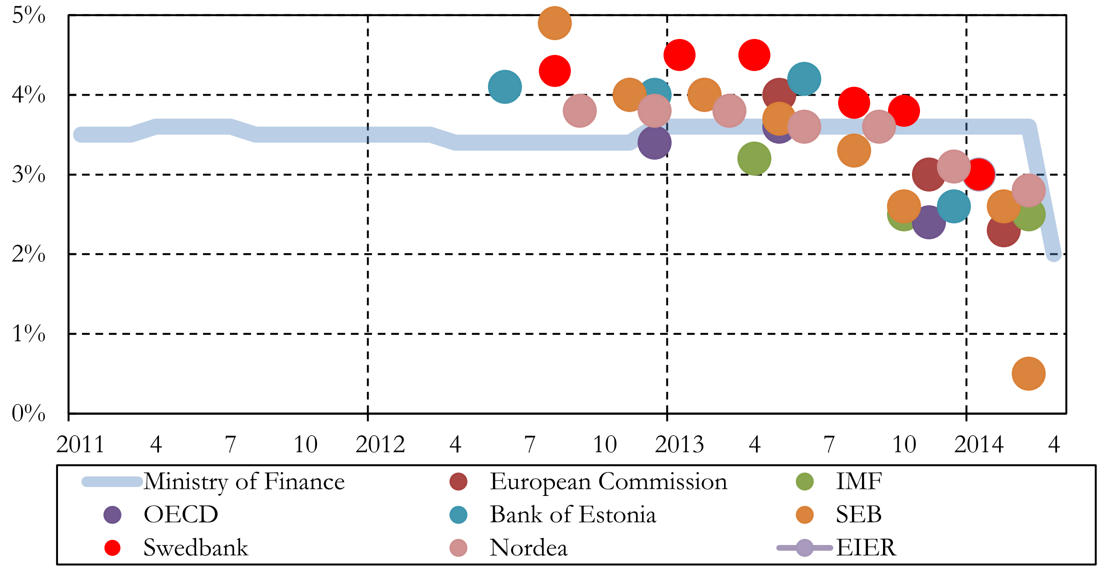
| | Consumer price index, % | | | General government budgetary position, % of GDP | | |
|---|---|---|---|---|---|---|
| | 2014* | 2015* | 2016* | 2014* | 2015* | 2016* |
| **Ministry of Finance** | **1.4 (1.7*)** | **2.7 (2.9*)** | **2.8 (3.0*)** | **-0.7** | **-0.8** | **-0.7** |
| European Commission | 1.8* | 2.8* | – | -0.4 | -0.4 | – |
| Bank of Estonia | 2.1 (2.3*) | 2.9 (3.0*) | – | -0.3 | -0.1 | – |
| IMF | 2.8* | – | – | – | – | – |
| OECD | 3.2* | 3.3* | – | -0.1 | 0.0 | – |
| SEB | 0.6 | 2.6 | – | -1.2 | -1.2 | – |
| Swedbank | 2.6 | 2.9 | – | -0.4 | -0.3 | – |
| Nordea | 1.9 | 3.0 | – | -0.5 | -0.1 | – |
| Estonian Institute of Economic Research | 2.5 | – | – | – | – | – |

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

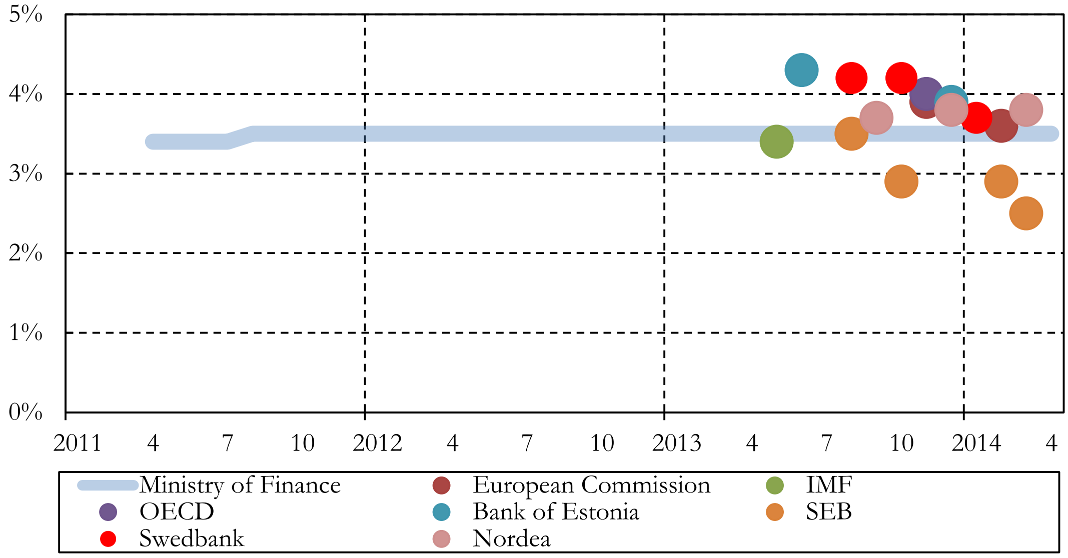
*Sources:*
*Ministry of Finance Economic Forecast. Spring 2014. 07/04/2014.*
*European Commission. European Economic Forecast Winter 2014. 25/02/2014*
*Bank of Estonia. Monetary policy and economy. 12/12/2013.*
*IMF. World Economic Outlook. October 2013. 08/10/2013.*
*OECD Economic Outlook No. 94, November 2013. 19/11/2013.*
*SEB. Eastern European Outlook. March 2014. 26/03/2014.*
*Swedbank. Swedbank Economic Forecast. 21/01/2014.*
*Nordea. Economic Outlook. March 2014. 12/03/2014.*
*Estonian Institute of Economic Research. Konjunktuur No 4 (187) 2014. 07/01/2014.*

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

### A. Forecasts of Estonia's economic growth for 2014 according to forecast publication date



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




*Sources: Ministry of Finance, Bank of Estonia, European Commission, IMF, OECD, Swedbank, SEB, Nordea, Estonian Institute of Economic Research (EIER).*

## 2. Fiscal forecast

In 2014 general government **budgetary position** is in deficit by 0.7% of GDP. Most of the deficit comes from central government but also local governments will be in deficit. The central government deficit is affected by investments which are linked to the revenue of $CO_2$ quotas and extra contributions of II pillar pensions (together -0.5% of GDP in 2014). Social security funds are still in surplus due to Unemployment Insurance Fund (0.2% of GDP in 2014). In 2015 the general government budget deficit increases to 0.8% of GDP. Most of the deficit comes still from central government, because state budget expenditure growth exceeds revenue growth partly due to reduction of income tax rate. At local government's level the budgetary deficit remain the same level (0.2% of GDP). At the same time social security funds contribution to the budgetary position is increasingly positive. According to forecast the budget surplus 0.9% of GDP will be achieved in 2018.

In 2014 the **tax burden** is forecasted to be at 32.4% of GDP which is 0.1 percentage points higher than in 2013. This year the increasing of additional allowance for pensioners decreases and rising of alcohol and tobacco excises increases tax burden. In 2014–2017 there are higher II pillar pension payments by government which technically decreases tax burden. In 2015 the income tax rate will be reduced to 20%. During 2015–2018 tax revenues will grow annually 0.5 percent slower than GDP and tax burden decreases to 31.7% of GDP.

The **general government debt** of Estonia in 2013 amounted to 10.0% of GDP, which is 0.2 percentage points more than in 2012. The main reasons for the government debt increasing were an increase in loans issued by European Financial Stability Fund (EFSF) and an increase in debt of local governments in connection with elections in autumn 2013. In 2014 and 2015 the general government debt can be expected to decrease, amounting to

9.3% of GDP by the end of 2015. In 2016 there will be a temporary increase to 9.4% of GDP in connection with the need to finance budget deficit, after that the debt will start to decrease again, amounting to 8.5% of GDP by the end of year 2018.

At the end of 2013, the **general government liquid financial assets** (reserves) constituted 9.9% of GDP. Due to the state budget deficit and investments that need to be financed, the reserves are expected to decrease and comprise 6.6% of GDP by the end of 2017. Thereafter the amount of reserves will start to increase again, amounting to 7.0% of GDP by the end of 2018.

**Net debt of general government** comprised 0.1% of GDP in 2013. The net debt is forecasted to increase to 2.6% of GDP by the end of 2016, after that it will start to decrease, falling to 1.5% of GDP by the end of 2018.

**Table 6.General government budgetary position, debt and tax burden 2013–2018 (% of GDP)**

| | 2013 | 2014* | 2015* | 2016* | 2017* | 2018* |
|---|---|---|---|---|---|---|
| **Budgetary position** | | | | | | |
| **1. General government** | **-0.2** | **-0.7** | **-0.8** | **-0.7** | **-0.1** | **0.9** |
| 2. Central government | -0.1 | -0.7 | -0.9 | -0.9 | -0.2 | 0.6 |
| 3. Other general government | -0.1 | 0.0 | 0.1 | 0.2 | 0.0 | 0.3 |
| social security funds | 0.3 | 0.2 | 0.3 | 0.4 | 0.4 | 0.5 |
| local governments | -0.4 | -0.2 | -0.2 | -0.2 | -0.4 | -0.2 |
| **Debt burden** | | | | | | |
| **4. General government** | **10.0** | **9.8** | **9.3** | **9.4** | **9.1** | **8.5** |
| 5. Central government (incl. EFSF) | 6.6 | 6.3 | 5.8 | 6.0 | 5.5 | 5.0 |
| 6. Local governments | 3.5 | 3.5 | 3.4 | 3.4 | 3.6 | 3.5 |
| **Tax burden** | **32.3** | **32.4** | **31.9** | **31.6** | **31.6** | **31.7** |

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

**Table 7. Structural balance 2013–2018 (% of GDP)**

| | **2013** | **2014*** | **2015*** | **2016*** | **2017*** | **2018*** |
|---|---|---|---|---|---|---|
| 1. Cyclically adjusted balance | 0.3 | -0.2 | -0.5 | -0.7 | -0.4 | 0.6 |
| 2. One-off measures | -0.2 | -0.3 | -0.5 | -0.4 | -0.3 | 0.0 |
| 3. **Structural balance** (3)=(1)-(2) | **0.4** | **0.1** | **0.0** | **-0.4** | **0.0** | **0.6** |

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