Eesti Pank

ESTONIAN ECONOMY AND MONETARY POLICY

2/2013

The Estonian Economy and Monetary Policy is published by Eesti Pank twice a year — in spring and autumn. The overview includes analyses of current economic developments as well as the central bank's forecasts for the coming years.

The Estonian Economy and Monetary Policy is available at http://www.eestipank.ee and is free of charge to subscribers.

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ISSN 1736-7867
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Printed in Folger Art

CONTENTS

ECONOMIC FORECAST 2013-2015

The Eesti Pank economic forecast is produced jointly by experts from the central bank's Economics and Research Department and Financial Stability Department. The forecasts are compiled using EMMA, the macro-model of the Estonian economy developed and regularly updated by Eesti Pank.

The forecast external assumptions are based on information available as at 20.11.2013, and the Estonian economic data available as at 14.11.2013.

SUMMARY

The Estonian economy developed in diverse directions in 2013, as employment rose despite the economic decline in the first two quarters and wage growth accelerated. Major developments for the economy also started in the labour market as the lack of available labour resources and the consequently improved position of employees in wage negotiations created a chain of economic growth based on rapid wage and domestic demand growth, which helped to offset the impact of weak external demand. The growth based on domestic demand was primarily driven by higher household incomes and consumption, while capital formation remained at close to the same level as in the previous year. A small and open economy can only develop on the back of domestic demand for a short while, and in the long run a continued increase in exports will be required for economic growth to be assured.

The risk of a weak recovery in the external environment that was identified in the previous forecast was realised in the first half of 2013, and support for economic growth from exports was lower than expected due to weak demand in Estonia's neighbours. As a result the growth rate for 2013 will be lower than was forecast in June. The slowdown in growth has not been broadly based, and growth has mainly slowed in business areas handling the transit trade, which have been affected by both the overall reduction in economic activity around the world, and by increased competition in the Baltic region. The growth in value added from other industries did not slow down in the first half of 2013, and as economic activity declined in 2013 because of temporary factors that should have a diminishing effect during the forecast horizon, an acceleration in growth is expected in 2014 and 2015.

The euro area recovered at about the expected speed in 2013, and the economic decline that had lasted for six consecutive quarters came to an end in the second quarter. However, growth rates vary widely between different countries and Estonia was strongly affected by the performance of Finland, which was worse than expected. The joint forecast produced by the central banks of the euro area sees that the return to growth that started in 2013 will continue and growth will accelerate slowly in the single currency area over the next two years. The recovery will be subdued as the process of unwinding the problems that have accumulated in the preceding years will take time. However, the imbalances in the countries in the bailout programmes have lessened, and this has improved confidence in the continuation of the recovery.

The gradual recovery in demand and the fall in prices of food commodities and energy have restrained inflation in the euro area, where it will remain below the target of two percent in the coming years. Weak price pressures mean that interest rates are expected to remain very low throughout the forecast horizon. This is backed up by the forward guidance from the European Central Bank, which has said that monetary policy interest rates will remain low for an extended period of time.

Interest rates have been low in the Estonian lending market for some time and access to bank loans is good but even so, growth in fixed capital formation came to a standstill during 2013. The need for investment among companies is low as the production capacity that was built up in 2012 in expectation of a recovery in external demand remains underused. The need

for additional production resources will arise if growth in external demand picks up and export opportunities improve, and for this reason capital formation in Estonia will increase through corporate investment. A recovery in investment activity will require support from the banking sector, which is particularly important for the financing of small and medium sized enterprises as they have limited access to other sources of funding.

A small but constant fall in employment is expected in 2014-2015 because although the recovery in economic growth will raise demand for employees, negative natural population growth and migration will reduce the labour force and employment. Despite the fall in employment, the unemployment rate will continue to fall. The fall will be gradual in the coming years though, because the current workforce can be employed more intensively through increases to the working hours that were cut after the crisis.

The factors that have spurred wage growth in 2013 will not go into retreat and in 2014 and 2015 the minimum wage will rise, as will the public sector payroll in 2014. The driver of rapid wage growth in the next few years will still be the improved position of workers in wage negotiations following the reduction in available labour and emigration.

Having slowed in 2013, inflation will remain moderate for the next two years. Core inflation based on domestic factors will be pushed higher by the rise in wage costs, but energy costs will hold back the general rise in prices. At the start of 2014 the comparison base effect of the sharp rise in electricity prices will fade and price pressures will also be held down by the fall in oil prices caused by the appreciation of the euro. Economic activity in the euro area will increase gradually and so the growth in prices of imports will be subdued, which will balance the faster rise in prices of Estonian products.

The nominal fiscal position of the general government will remain close to balance but slightly in deficit throughout the forecast horizon and the structural budget balance adjusted for the economic cycle will remain in surplus. The indicators of the economic cycle for 2013 are quite contradictory and the assessment of the structural fiscal position could be noticeably out, and so fiscal policy needs to aim for nominal balance or a surplus. The resolution of the debt crisis in the euro area has repeatedly been postponed and the risks remain, so it is important that reserves be created to cover unexpected setbacks.

The risks around the outlook for the Estonian economy are again related to growth in exports. Sustainable growth in the economy needs Estonian exports to grow faster and the contribution to economic growth of value added in exports to increase. Exports may grow more slowly than forecast for several reasons. Firstly, stronger growth in external demand may again be delayed, though this is somewhat less likely than it was earlier, and secondly, pressure on costs caused by wage rises at home might restrict growth in exports. Many of the companies that are oriented towards the domestic market have so far managed to pass increased wage costs on into the end prices of products but this option is not open to companies facing foreign competition, as competing exporters have seen only modest price rises due to the sluggish levels of activity. If exporting industries cannot manage to compensate for wage growth by increasing productivity, then companies in the exporting sector may have to reduce numbers of employees in order to maintain their profitability, and this could lead to a rise in unemployment.

This forecast contains four boxes of background information. The first reviews the latest development trends in the monetary policy of the euro area, the second explains the discrepancies in the economic indicators for the first half of 2013, the third looks at the structure of Estonia's main external trading partners by value added in exports and the fourth identifies the main factors causing wage growth to accelerate despite the slowdown in economic growth.

THE EXTERNAL ENVIRONMENT

Growth in advanced economies has generally been in line with the June forecast, which expected a gradual economic recovery in 2013. Emerging markets have, however, grown more modestly than forecast, which has both a direct and an indirect effect on Estonian export markets. The sluggishness of economic activity has meant that pressure on the prices of commodities has been low, and this has held down inflation around the world.

The main policy for increasing economic activity in advanced economies is monetary policy, which is likely to remain loose for some time yet. However, this forecast uses the assumption that short-term European interbank interest rates will rise slightly. The 3-month EURIBOR will rise on average to 0.48% in 2015 (see Table 1).

The drag of budget consolidation on growth in advanced economies will lessen as many countries have already made the largest of the planned cuts. Fiscal policies in emerging markets have been quite accommodative in the last five years and so it will be harder for those countries to boost their economies further through budgetary means, and they will need to consider instead budget cuts and structural reforms.

Fears of a tightening in the monetary policies of advanced economies have worsened the borrowing conditions for emerging markets, and this has reduced economic activity. The realisation of the risk of a sharp tightening of monetary or fiscal policy in advanced economies could slow economic growth in emerging markets even further if, for example, the United States were to fail to raise its debt ceiling in 2014.

A slowing of growth in emerging markets would have a negative impact on advanced economies through economic links. This would particularly affect countries in Central and Eastern Europe, including the Baltic states, as emerging markets, particularly Russia, take a relatively large share of their exports. Russia took 12% of total Estonian exports in 2012 and a slowdown in Russian growth also affects Estonia through other trading partners where Russia is also a major destination for exports. Russia took 10% of total exports from Finland in 2012, 18% of exports from Latvia and 19% of exports from Lithuania.

Demand from Estonia's trading partners grew less quickly than was assumed in June. The June forecast expected that external demand would grow by 2.4% in 2013, but data from the first half-year indicate that growth has been slower than that. This forecast uses the assumption that external demand will recede by 0.3% in 2013. Expectations for growth in the economies of trading partners are also somewhat reduced for 2014 and 2015 and external demand is expected to grow by 3.9% in 2014 and 5.2% in 2015. Smaller growth in external demand is mainly a consequence of more modest economic growth than was expected in Sweden, Finland and Russia, which are Estonia's main trading partners.

Table 1. External assumptions in the forecast

					June 2013 projection		
	2012	2013	2014	2015	2013	2014	2015
Foreign demand growth (%)*	2.5	-0.3	3.9	5.2	2.4	4.7	5.6
Oil price (USD/barrel)	112.0	108.2	103.9	99.2	105.5	100	96.2
Interest rate (3-month EURIBOR, %)	0.57	0.22	0.27	0.48	0.21	0.31	0.52
USD/EUR exchange rate	1.28	1.33	1.34	1.34	1.31	1.31	1.31

* Foreign demand growth is the weighted growth of imports of trading partners
Source: European Central Bank

Price pressures for commodities have remained low due to the weak growth in the global economy (see Figure 1). This forecast expects the oil price to fall to an average of 99.2 USD per barrel in 2015. Food commodity prices will start to rise gradually after the past decline and for 2014 as a whole, prices of food commodities in the European Union will fall by 0.6%, and they will rise by 3.3% in 2015.

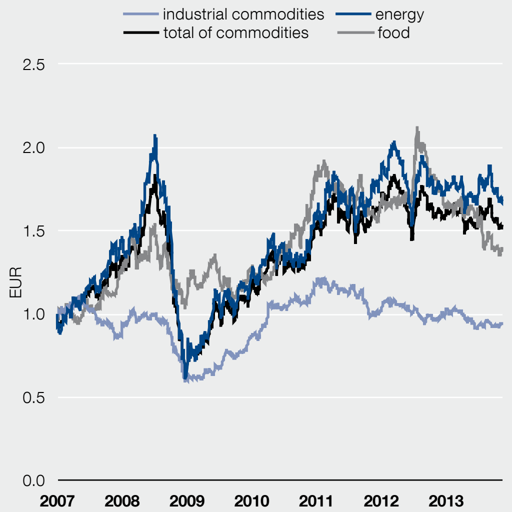
The United States of America

Growth has recovered in the USA faster than in other developed countries with help from accommodative monetary and fiscal policies. Growth in 2013 is likely to be slower than it was in 2012 due to budgetary consolidation, but in the coming years it should speed up again (see Figure 2). It is currently unclear how large and how long-term the impact of the government shutdown in 2013 will turn out to be.

The fiscal problems in the USA pose a negative risk to global economic growth. It is forecast that it will be necessary to raise the debt ceiling again, and if this is not done there could be a broad-ranging impact on the global economy. If the US delays payments on its debts, borrowing would become more expensive and this would probably affect the borrowing costs of other countries too, particularly emerging markets, while sharp budget cuts would lessen economic activity in the USA.

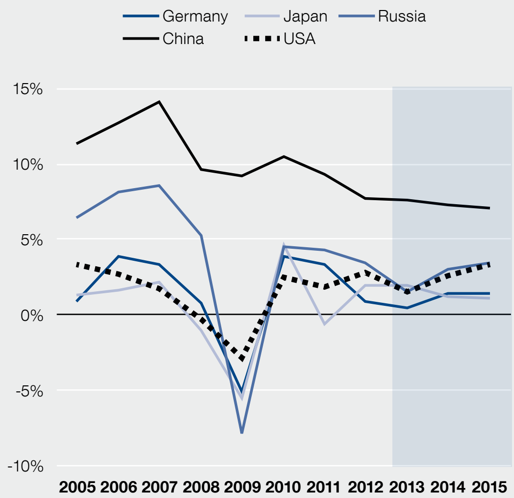
Inflation has remained low in the US in 2013, partly because of underused capacity in the economy, and also because the oil price has fallen. Long-term expectations for inflation do not seem to have been lowered, and if activity increases, inflation should return to its normal level of around two percent.

Figure 1. Commodity price indices*
(index: Jan 2007=1)



* last observation 15.11.2013
Source: HWWI

Figure 2. Output growth of larger economies



Source: IMF WEO, October 2013

Unemployment has fallen in America from the high levels it reached after the Lehman crisis and having risen to 10% in autumn 2009 it fell below 7.5% by the middle of 2013. Unemployment has fallen not only because of increased employment but also due to a fall in the labour market participation rate. Future growth in employment and a rise in the participation rate will help to increase disposable income for households and household consumption. Employment growth will support a rise in domestic demand and thereby a recovery in the economy.

Europe

Economic growth in Europe in recent years has mostly been seen in countries that do not have problems that stem from economic imbalances or where such problems are only minor. There has also been some initial improvement in recent years in the economic indicators of countries facing problems with the sustainability of their sovereign debt. The Portuguese economy grew by 1.1% in quarterly comparison in the second quarter of 2013 and by 0.1% in the third quarter according to preliminary data. Preliminary data suggest that the economy in Spain also grew by 0.1% in the third quarter. In northern Europe, Finland and Sweden saw growth slow somewhat during the past year, and this has had a direct impact on Estonia because of the close trade links.

To the south of Estonia, economic growth in Latvia and Lithuania was boosted by the improvement in competitiveness following the recession and the subsequent growth in exports. The weakness of the external environment has also had an inhibiting effect on growth in those two countries, though the effect has not been as strong as in Estonia. The Latvian economy grew by 4.1% in the first half of 2013, and the Lithuanian economy by 3.6%. Both economies are increasingly being supported by domestic demand, which has increased mainly due to the increased consumption allowed by growth in household incomes. Growth has accelerated in both Latvia and Lithuania because of the re-utilisation of production capacity that was left idle during the recession. Manufacturing capacity is now being used in the two countries to almost the same extent that it was before the crisis, which means that the need for investment from companies will also recover. Investment will also get a boost when Latvia joins the euro, inasmuch as that will increase confidence in the Latvian economy.

The European Union economy as a whole started growing again in quarterly terms in the second quarter of 2013. This was partly because the exceptionally cold weather in the first quarter meant that GDP growth was weak in many countries and so growth in the second quarter was faster because of the low comparison base. The flash estimate of GDP shows that quarterly growth in the European Union was 0.2% in the third quarter and confidence surveys indicate that the outlook for growth in the economic area will improve further.

The short-term negative impact of fiscal consolidation has eased and some structural reforms have been made, and this has helped accelerate growth in the European Union as a whole. The acceleration in growth is still slow however, as the challenges of imbalances in many countries still need to be tackled and there is a continuing Europe-wide need for more cuts to be made. The autumn 2013 forecast by the European Commission finds that 14 European Union member states will exceed or touch the budget deficit limit in the Stability and Growth Pact of 3% of GDP in 2014.

Unemployment is high in the majority of European countries and is above its historical average. Exceptions to this include Germany and the United Kingdom, where the recovery after the crisis has seen rapid increases in employment. Inflation has been quite modest in Europe in 2013 as economic activity has been weak and low inflation led the European Central Bank to cut base interest rates in November to the lowest levels yet seen in the monetary union (see Box 1 for further details).

Japan

The Japanese economy has grown faster than usual in recent years, growing by 2% in 2012 and, according to the forecast published by the International Monetary Fund in October, by the same amount again in 2013. The economy has been helped by accommodative monetary and fiscal policies and has also been affected by the depreciation of the yen, which has improved competitiveness. Increased economic activity has given rise to higher inflation expectations, and inflation will be boosted in 2014 and 2015 by rises in consumption taxes intended to improve the fiscal position. Tax rises mean that growth may slow in Japan in 2014.

Japan has embarked on a new course in economic policy of stimulating demand widely through both monetary and fiscal policies. The government has also promised structural reforms and higher spending on research and development. These policies have been criticised though as they could threaten the long-term sustainability of the Japanese economy, as Japanese government debt is already around 250% of GDP.

China

Growth in the Chinese economy is slowing steadily, but will still remain notably faster than growth in advanced economies (see Figure 2). It has been supported during the last year by fiscal policy and rapid credit growth, but these effects should gradually recede. Although China's sovereign debt is much smaller than those of advanced economies, it has been growing fast and this means that China can probably not continue with a loose fiscal policy. It is necessary to restore fiscal sustainability in case the bubble in private sector credit bursts. Private sector debt in China grew by an average of over 20% a year in 2007-2012 and loans from the Chinese banking sector to businesses and households reached 116% of GDP in 2012. The actual debt of the private sector was even larger as lending from outside the banking sector has increased rapidly in recent years. It is probable that China will have a soft landing with the necessary reforms being carried out and the structure of the Chinese economy being edged more towards consumption.

Box 1: The monetary policy environment in the euro area

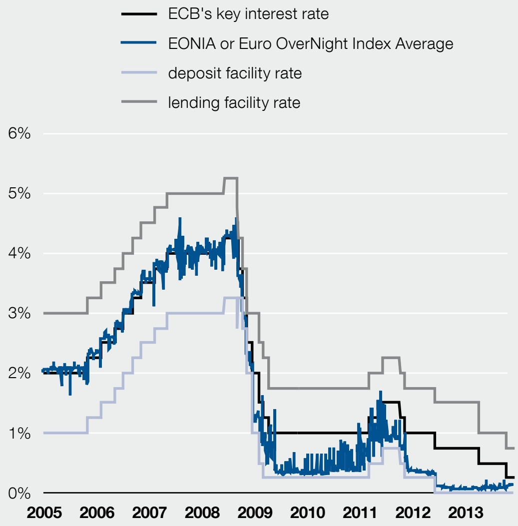
In the second half of 2013 the monetary policy environment was favourable in the euro area. At the beginning of November the Governing Council of the European Central Bank decided to lower the interest rate on the main refinancing operations to 0.25% and the interest rate on the marginal lending facility to its lowest-ever level under the economic and monetary union of 0.75%, while keeping the interest rate on deposit facility at its record low of 0.00% (see Figure B1.1). Annual growth in the harmonised index of consumer prices (HICP) has slowed steadily throughout the year and has been below 2% since February, dropping as low as 0.7% in October, though it picked up to 0.9% in November. The main causes of this were a fall in energy prices and low levels of economic activity. There was also an effect from the fiscal consolidation in the euro area member states, where the impact of higher indirect taxes and administrative prices on the comparison base for price rises has recently been significantly reduced and has held down the annual growth in the HICP. Inflation could be subject to upward pressure from unexpected rises in energy prices and indirect taxes, including excise duties. The assessment of the European Central Bank is that inflationary risks in the euro area will be on the upside and in line with the Eurosystem's aim of keeping inflation rates below but close to 2% over the medium term.

The annual growth rate of the broad monetary aggregate M3 slowed from 3.2% in April to 1.4% in October (see Figure B1.2). Short-term deposits continue to be the largest contributors to the growth in the money supply, though their growth has slowed in the second half of the year, falling to 6.6% in October. In an environment of low interest rates and diminished but continuing uncertainty it appears that economic agents prefer to invest their money primarily in the most liquid instruments. The volume of money market funds that are included in the broad monetary aggregate M3 is still very small, and its annual growth rate has been negative throughout 2013. This is a consequence of the low interest rates and the low returns of money market funds. Lending to the real sector in the euro area has been modest, and its annual growth[1] has remained negative in the second half of 2013, falling to -2.1% in October. The fall has been sharper in corporate borrowing, which was down 3.7% in October, than it has in household borrowing, which continues to post positive growth and stood at 0.1% in October. However, the latest Bank Lending Survey[2] of the euro area shows

1 Adjusted for loan sales and securitisation.

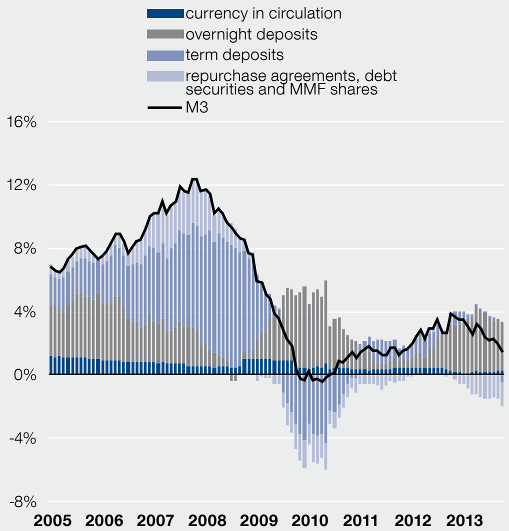
2 http://www.ecb.europa.eu/stats/money/surveys/lend/html/index.en.html. Stricter lending conditions are interpreted in the survey by analysing the net difference in the shares of those banks that have noted in the review that they have tightened their lending conditions, such as interest margins or collateral demands, and those banks that said they have loosened their terms. A positive net rate means that a majority of banks have tightened their lending terms.

Figure B1.1. Eurosystem key interest rates and EONIA*



*last observation 28/11/2013
Sources: European Central Bank, Reuters/Ecowin

Figure B1.2. Euro area annual money growth*



* last observation October 2013
Source: European Central Bank

that the speed of the tightening of lending conditions to the non-financial sector has been reduced gradually but loan demand from companies in particular remains low due to the high leverage and uncertainty about future economic developments. There are also significant differences between the member states of the monetary union in the lending and borrowing behaviour both of banks and of companies and households. Growth in loans to the non-financial sector in Southern Europe is weaker than elsewhere in the euro area, and in consequence so is the recovery in economic activity.

On top of its traditional monetary policy measures, the Eurosystem has continued with its non-standard monetary policy measures to support the functioning of transmission channels. Although no transactions have yet been made under the Outright Monetary Transactions programme announced in autumn 2012, the measure has still had a positive impact on the financial markets of the euro area, lowering risk aversion among investors. The Governing Council of the European Central Bank decided at the start of November to extend the fixed rate full allotment or FRFA tender until at least the summer of 2015. From 2013, credit institutions in the euro area have been able to pay back early the loans they had taken under the three-year long-term refinancing operations[3]. At the start of 2013 the fall in the total outstanding volume of such loans was somewhat larger than that in recent months. This repayment of liquidity to the Eurosystem shows that the liquidity position of the euro area banks continues to improve gradually, though it is doing so more slowly in Southern Europe. At the end of November the euro area banks had repaid 50% of what was borrowed in the first three-year operation, and 27% from the second operation, making a total value repaid of 389 billion euros. The Governing Council of the European Central Bank used forward guidance for the first time in communicating its monetary policy decisions in July, noting that key interest rates would remain at present or lower levels for an extended period of time due to the subdued outlook for inflation and economic growth[4]. Prior to this, volatility in the money market interest rates had increased significantly, making expectations for future monetary policy developments more vulnerable to external shocks that are not directly linked to the dynamics of economic indicators and monetary aggregates. In this way the change in circumstances could threaten the price stability goals of the European Central Bank. The effect of this innovation was that volatility in short-term money market interest rates fell, particularly for the forward rates based on overnight index swaps.

The central bank influences short-term interest rates in the money markets through its key interest rates[5] and as long-term interest rates also depend on the expectations for short-term rates, it is important to follow events in the money markets carefully. EONIA[6] has been very low since July 2012 and at the end of November 2013 it stood at 0.12%, meaning it was

3 In December 2011 the first three-year long-term refinancing operation was run for a total value of 489 billion euros, followed by a second operation in February 2012 for 530 billion euros. In total the two operations lent out 1.02 trillion euros to credit institutions of the euro area. Credit institutions that have taken the loans have the right to pay it back after one to three years.

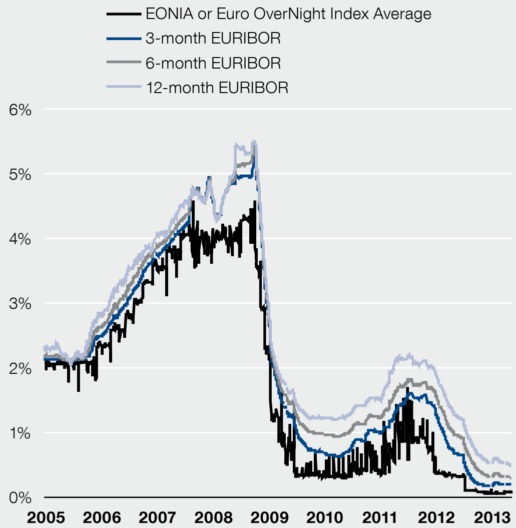
4 ECB press conference, 4 July 2013 http://www.ecb.europa.eu/press/pressconf/2013/html/is130704.en.html. ECB Monthly Bulletin Editorial, July 2013 http://www.ecb.europa.eu/pub/pdf/mobu/mb201307en.pdf. Forward guidance has been used by the central banks of the USA, Canada, New Zealand and the United Kingdom.

5 Interest rates fixed for up to one year.

6 Euro OverNight Index Average for overnight lending between banks in the euro area.

hovering around 10 basis points higher than the interest rate on the Eurosystem's deposit facility. At the end of November the short-term money market interest rates were down on the levels of the end of May, with the three-month EURIBOR[7] 3 basis points lower at 0.23%, the six-month EURIBOR 3 basis points lower at 0.33%, and the twelve-month EURIBOR 2 basis points lower at 0.50%. However, the three-month rate was 1 basis point higher than at the start of January and the twelve-month rate was 4 basis points lower (see Figure B1.3). Short-term money market rates have generally followed the consistently low European Central Bank key interest rates. The spread between the one-month and twelve-month EURIBORs, which indicates the shape of the money market yield curve, remained similar in November to what it had been in May at around 40 basis points. Low interest rates in the money markets lower the interest burden for borrowers, but they have also pushed banks to cut their deposit interest rates. This may lead economic agents to start to search for higher yielding investments or divert their funds instead towards consumption.

Figure B1.3. Euro area money market interest rates*



*last observation 28.11.2013
Source: Reuters/Ecowin

7 Euro Interbank Offered Rate for lending between banks across Europe.

ECONOMIC ACTIVITY

Since the crisis, the Estonian economy has grown quite fast, though growth slowed significantly in the first half of 2013 and is now below the level forecast in June.

The reason that growth has been less than forecast is that the economies of Estonia's trading partners have grown only modestly, and this has restricted growth in the exporting sector. Household consumption has grown faster than forecast though, which has compensated for the weak external demand.

The slowdown in growth in the first half of 2013 was relatively narrow-based (see Box 2) and was mainly due to a reduction in value added in transport and storage and in construction. Growth slowed in manufacturing in the second and third quarters as exports to markets outside the euro area fell. Quarterly growth returned to the economy in the third quarter and the flash estimate from Statistics Estonia put growth for the economy at 0.4%. The main driver of growth was the retail and wholesale sector, which was lifted by increased household consumption.

Value added from the construction sector fell by 5.4% at constant prices in the first half of 2013. At the start of the year the fall was a consequence of the unusually late arrival of spring, with the coldest March in twenty years, and a reduction in economic activity in Finland which led to a fall in the amount of building work abroad for Estonian firms. The construction sector is increasingly affected by the decline in investments funded by sales of emissions quotas and the change of budget period for subsidies from structural funds. This implies that demand for building services may remain lower than it has been throughout the forecast horizon.

Value added from transport and storage fell by almost 16% in the first half of 2013. The fall came from individual companies that are mainly in the motor fuel transit business, and it did not affect the Estonian economy more broadly. Tougher competition between ports around the Baltic Sea will put limits on development for transport and storage in Estonia in the next few years and this will affect maritime, rail and road transport. European Union environmental restrictions on ships moving in the Baltic Sea will become stricter and this could lead to changes in the internal structure of the sector in the coming years. Larger international trade flows will help transport and storage to return to growth, though the growth of trade volumes is forecast to remain below its pre-crisis rate throughout the forecast horizon.

The developments in Estonian manufacturing have reflected those in the external environment. Growth slowed in manufacturing in the middle of 2013 as demand in export markets was weaker than had been expected. Manufacturing output declined in monthly terms from June to September but exports to the euro area grew in September, which shows that the recovery in the euro area has probably begun. However a large share of manufacturing exports goes outside the euro area and these exports declined. The development of manufacturing is closely connected to activity in trading partners and so a recovery in external demand during the forecast horizon will lead to faster growth in manufacturing.

Accelerating growth in exports will make manufacturing one of the main contributors to economic growth according to the forecast. However, faster wage growth could threaten the competitiveness of the manufacturing sector, leaving

Figure 3. Output growth and productivity

Sources: Statistics Estonia, Eesti Pank

growth slower than previously expected. In the industry surveys by the European Commission, Estonian manufacturers say that improvement of their competitive position has become more constrained in 2012 and 2013.

GDP growth in Estonia in recent years has been quite employment intensive, while the productivity of labour has grown to a lesser extent (see Figure 3). Although the productivity of labour grew a lot in 2010, this was more due to the recovery of capacity utilisation following the economic decline than to any increase in qualifications and skills. Although the economic growth has been inclusive thanks to the rapid growth in employment, higher employment alone will not support growth over the long term.

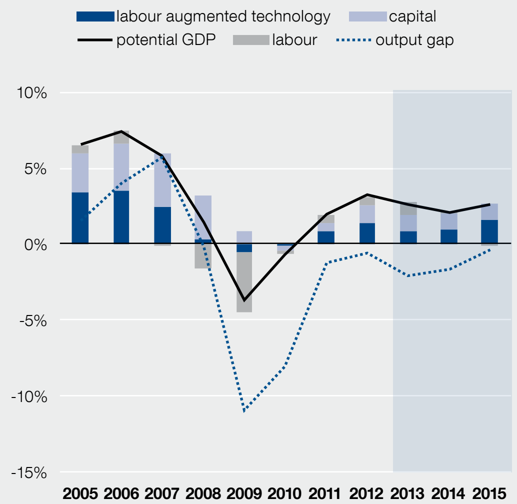
Low growth in labour productivity may be a consequence of low levels of investment and slow advances in the skills of employees and in technology. Many workers lost their job-specific skills when they lost their jobs during the crisis, and it takes time for them to regain the skills in a new job. Skills can also be degraded by long periods of unemployment. External demand has remained weak since the recession and capacity utilisation still remains below the pre-crisis level. In this case companies often prefer to increase the utilisation of current machinery rather than to invest in new technology, and for this reason overall investment has remained lower than before and so has growth in physical capital like machinery and equipment or buildings and facilities.

Growth in labour productivity has been slow since the economy went into decline and this together with the rapid rise in employment indicates that potential growth may have slowed temporarily. The estimate for potential growth for the forecast period is on average about one percentage point lower than was expected in the June forecast.

The forecast projects that the slowing of labour productivity and potential GDP growth will prove temporary and potential growth will accelerate to close to three percent by the end of 2015 (see Figure 4). In this, potential growth is mirroring the one-off impact of the crisis and there is no effect on long-term growth or income convergence with the European Union. Potential growth will continue to accelerate for some time beyond the forecast horizon, supported by the growth in the supply of physical capital in the economy and by advances in technology, which is a sign of an improvement in the skills and knowledge of human capital, and in the use of new production technology.

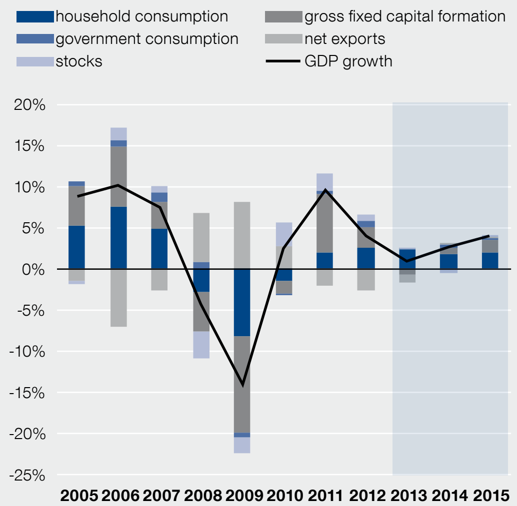
Another factor that increasingly affects growth alongside the productivity of labour is the decline in the working age population as the total population ages. This effect will be mitigated during the forecast horizon by a rise in the participation rate stemming from the age structure of the working age population and by a fall in structural unemployment. A fall in structural unemployment

Figure 4. Potential growth and the output gap



Sources: Statistics Estonia, Eesti Pank

Figure 5. GDP growth by expenditure method



Sources: Statistics Estonia, Eesti Pank

achieved through better re-training and additional training and policies to raise the participation rate would help to alleviate the shrinking of the working age population.

The impact of growth in 2013 being slower than expected will be felt in 2014 and this forecast projects the Estonian economy to grow by 2.6% in 2014 and the growth to accelerate to 3.9% in 2015 (see Figure 5). Faster economic growth will need a recovery in the economies of Estonia's main trading partners, though this is expected to be slower than was assumed in the June forecast.

The utilisation rate of production capacity in Estonia in 2013 was below normal which means that actual production capacity was below potential and the GDP gap was negative. The acceleration in growth up to 2015 will partly be built on unutilised production capacity being brought into use, and the forecast projects the GDP gap to close by the end of 2015.

Growth in the Estonian economy in 2013 was largely based on increased household consumption, which was backed by rapid rises in wage income (see Figure 5). Growth in the forecast period will be based more on the exporting sector and in 2014 export growth will exceed import growth and the contribution of net exports to GDP growth will become positive. Increased investment activity in 2015 will accelerate import growth, so during the year the contribution of net exports will turn negative.

The forecast for the main economic indicators for Estonia is shown in Table 2.

Table 2. Economic forecast by key indicators*

					Difference from previous forecast		
	2012	**2013**	**2014**	**2015**	**2013**	**2014**	**2015**
Nominal GDP (EUR bn)	17.42	18.39	19.46	20.99	0.51	0.23	0.25
GDP, volume change (%)	3.9	1.0	2.6	3.9	-1.0	-1.6	-0.4
CPI, change (%)	3.9	2.9	2.1	2.9	-0.1	-0.4	0.2
HICP, change (%)	4.2	3.3	2.3	3.0	0.0	-0.4	0.0
GDP deflator, change (%)	3.3	4.6	3.1	3.8	1.5	-0.2	0.4
Current account (% of GDP)	-1.8	-1.9	-1.9	-1.5	-1.1	-1.1	-1.3
Private consumption expenditures, volume change (%)	4.9	4.8	3.4	3.9	1.8	0.0	0.0
Government consumption expenditures, volume change (%)	3.8	0.0	1.7	1.2	-1.0	0.2	-0.3
Gross fixed capital formation, volume change (%)	10.9	-2.8	3.6	6.1	-4.3	-3.2	0.6
Exports, volume change (%)	5.6	2.0	3.1	7.0	-5.9	0.0	1.0
Imports, volume change (%)	8.8	3.0	3.0	6.9	-2.8	-0.3	1.2
Unemployment rate (%)	10.2	8.7	8.5	8.3	-0.5	-0.3	-0.2
Domestic employment, change (%)	2.2	2.3	-0.4	-0.3	0.5	-0.5	-0.2
Productivity per employee, change (%)	1.7	-1.3	3.0	4.2	-1.5	-1.1	-0.3
Real compensation per employee, change (%)	2.2	0.8	3.7	4.7	-0.2	0.1	0.4
Average gross wage, change (%)	5.9	7.8	6.6	7.7	2.7	0.2	0.3
Private sector debt, outstanding amount change (%)	1.6	1.6	4.1	5.8	-2.1	-0.9	0.1
Gross external debt (% of GDP)	95.4	91.6	88.9	84.2	-2.7	0.1	1.4
Budget balance (% of GDP)	-0.2	-0.2	-0.3	-0.1	0.1	-0.3	-0.3

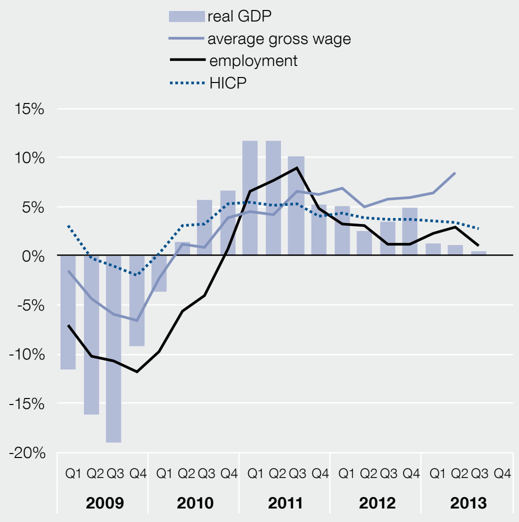
* GDP and its components are chain-linked
Sources: Statistics Estonia, Eesti Pank

Box 2: Estonian economic indicators for the first half of 2013

The first half of 2013 saw increased differences between the dynamics of several important economic indicators. Although the economy shrank in the first two quarters, data from the labour force survey by Statistics Estonia showed that unemployment declined and annual growth in employment accelerated to 3%. The decline in the economy also stood in contrast to the accelerated growth in average gross wages, which reached 8.5% in the second quarter. The rapid wage growth led to a rise in real unit labour costs and labour costs increased as a share of GDP to 47% in consequence. Despite the faster growth in production costs caused by higher wages, consumer price inflation continued its steady decline during this period (see Figure B2.1).

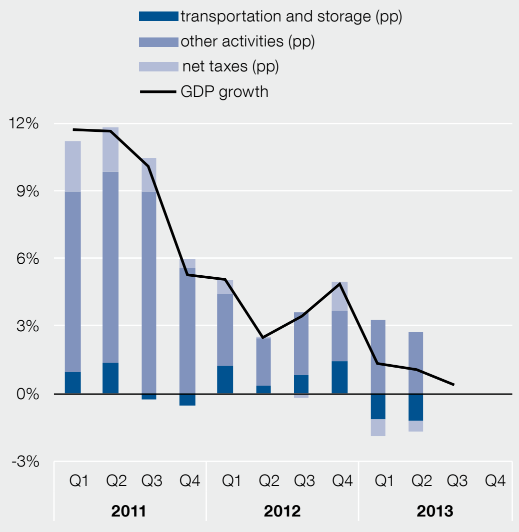
Some of the causes of the lack of consistency between the economic indicators are statistical, while others lie in the structure of the economy. Firstly, the slowdown in growth was concentrated in certain sectors and so did not affect the whole of the economy. The decline in GDP in the first half of 2013 was mainly focused in one activity, transport and storage, and if that activity is taken out, GDP would have grown by 2.6% rather than the 1.2% that it actually saw. The growth would have been even higher without the negative impact of net taxes on products, which is likely to be temporary, and in this case the value added generated in the economy would have grown by 3.2% in the first quarter of 2013 and 2.7% in the second quarter (see Figure B2.2). This shows that value added annual growth accelerated by 0.6 percentage points in the first half of 2013 if transport and storage is left aside.

Figure B2.1. Economic indicators, annual growth



Source: Statistics Estonia

Figure B2.2. Contribution of storage and transportation to GDP growth



Source: Statistics Estonia

One explanation for the rapid growth in employment found by the labour force survey in the first two quarters of 2013 is that the survey calculates employment using population estimates that have not yet been adjusted for demographic changes or migration. In consequence the population has been overestimated and this is reflected in the numbers for total employment. An alternative source, the wage statistics of the Estonian Tax and Customs Board, shows that the growth in the number of employees receiving wages has slowed since the start of 2012, which is more in line with the decline in economic activity. The labour force survey data for the third quarter of 2013 also indicate a slowdown in employment growth, though a better fit of the labour force survey time series with economic indicators may be expected at the start of 2014 when the revised time series for employment is published.

Wage growth was quite even across industries in the first half of 2013 reflecting broad-based growth in value added, though wage growth exceeded productivity growth somewhat, partly as a consequence of the raising of the minimum wage and the introduction of new agreements on pay in the public sector. The wage pressure is partly a consequence of the shortage of available labour resources and the ability of residents to go to work outside Estonia, which have together improved the position of employees in wage negotiations[8]. This is probably a structural change in the Estonian labour market and a new equilibrium has been reached with labour costs taking a larger share of GDP.

Estonian companies that focus on the domestic market have managed successfully to pass increased wage costs through into prices for end-products, and prices for services, which are more sensitive to wage costs, rose more rapidly in the first half of 2013. The pressure from wage rises is not however reflected in the total consumer price index as the fall in prices of durable goods and communications has held down core inflation, which is based on domestic factors including labour costs. It is forecast that the divergence between the various indicators in the first half of 2013 will recede as the impact of the factors that have caused it lessens.

8 The causes of accelerating wage growth are described in more detail in Box 4.

DOMESTIC DEMAND

Growth in the Estonian economy has been driven by domestic demand since 2012. Gross fixed capital formation and private consumption contributed roughly equally to domestic demand growth of 5.5% in 2012, but in 2013 it was the surge in private consumption growth that mainly supported the growth in domestic demand, while investment was actually slightly down on a year earlier. The stop in investment growth is forecast to cause domestic demand growth to slow to 2.2% in 2013 and it is expected that growth will be driven by private consumption until the middle of 2014. As external demand recovers, it will help production levels to rise meaning that companies will have to increase their fixed assets. The improving external demand will thus increase the contribution of investment to growth in domestic demand.

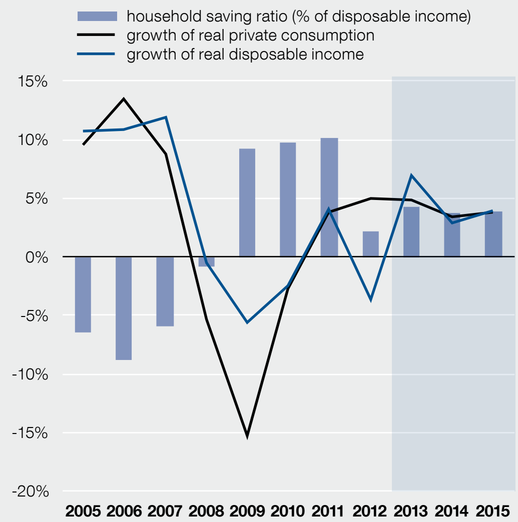
Private Consumption

Support from the labour market led private consumption to grow by 4.9% in 2012, and growth has remained strong in 2013. The rise in electricity prices pushed living costs up at the start of 2013, but the ability and willingness of consumers to consume were raised by higher incomes and improved expectations for the future, and by lower inflation in the second half of the year.

The share of household income spent on consumption has increased since the years of the crisis as the fear of unemployment has fallen. The structure of private consumption growth changed somewhat in 2012–2013. In 2010–2011 consumption largely increased through purchases of durable goods, but in 2012 and the first half of 2013 the growth in these purchases slowed and the share of consumption that went on services and non-durable goods increased. The final consumption expenditure of households is forecast to grow by 4.8% in 2013 and this will be the main factor contributing to domestic demand growth.

Private consumption will continue to support growth in the coming years and the forecast expects consumption growth to remain strong until the middle of 2014. This growth will be based on the increased confidence of households, continuing growth in incomes[9], and increased wealth as property prices rise[10]. Consumption will then grow at a similar speed to household disposable income, which rose sharply in 2013 due to the low comparison base from 2012[11]. The impact of the comparison base effect will fade away in 2014 and a certain slowing of growth in disposable income will reduce growth in private consumption slightly in the middle of the year. The forecast expects private consumption to grow by 3.4% in 2014 and by 3.9% in 2015. The savings rate, which shows savings as a share of disposable income and which has been very volatile since the crisis, is forecast to stabilise at close to 4% (see Figure 6).

Figure 6. Private consumption



Sources: Statistics Estonia, Eesti Pank

Gross Fixed Capital Formation

Gross fixed capital formation grew faster than GDP in Estonia in 2011 and 2012. Investments increased by 10.9% in 2012 and by the end of the year gross fixed capital formation was 28% of GDP, which is seven percentage points more than during the trough of investment two years earlier.

In the first half of 2013 gross fixed capital formation at constant prices fell slightly in annual terms, mainly because of reductions in investment by the government sector, which had climbed to record levels in 2012 with support from funds from abroad. Although investment is lower as a share of GDP in Estonia at the moment than it was before the crisis, it was the highest of any country in the European Union in the second quarter of 2013.

9 It has been agreed that pensions and the government sector wage fund will increase in 2014, that the minimum wage will rise in 2014 and 2015, and that income tax will be lowered by one percentage point in 2015.

10 The connection between consumption and property values is explained by the life cycle theory of consumption, which posits that households adjust their consumption spending and their saving when they get new information about their lifetime wealth, for example from a permanent change in their income or the value of their assets.

11 Despite rapid wage growth, the disposable income of households did not increase in 2012 as income from property fell.

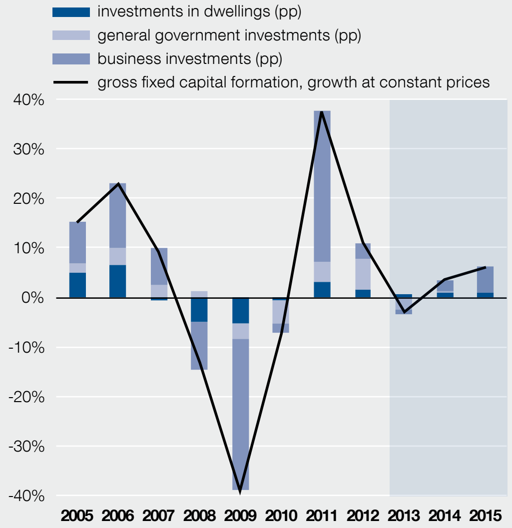
General government sector investments will shrink in 2013 as there will be a smaller volume of projects financed by income from the sale of emissions quotas and the European Union's funding period will come to an end. Investment by the general government sector in 2013 is forecast to be 10.9% lower than in the previous year. General government sector investments will not increase much in the next two years as it takes time for money to be distributed in the new European Union budget period. The impact of the lower availability of external funds will mainly be felt by investments in construction.

Gross fixed capital formation in the corporate sector at the start of 2013 was at the same level as in the previous year, but a slight fall in investment is expected for the year as a whole. The rapid growth in corporate investment faded in 2012 despite the low level of investment and the improved access to credit. Weak external demand meant that only a limited share of the production capacity of manufacturing companies was in use, and this inhibited growth in gross fixed capital formation in 2013 together with a lack of confidence among companies about future demand. Expectations for future orders picked up in autumn 2013 though and the utilisation rate of production capacity approached its historical average. If external demand recovers, further increases in production will require greater investment in fixed assets and for this reason an acceleration of growth in investment in the corporate sector is expected in the coming years.

The rapid growth in residential investment seen after the crisis will give way to moderate growth. Although capital formation in dwellings increased in 2012 by 11.7%, a certain slowing in growth in household investment could be observed at the end of the year. This was partly a consequence of the rapid rise in property prices and partly of a reduction in the supply of new residential property. Investment in housing will increase in 2013 by a little over 5% and similar increases are expected in the coming years. The moderate growth in household investment is supported by a favourable lending environment, high confidence among households, and growth in incomes. Statistics for building permits and dwellings completed also indicate growth in the supply of new residential space.

Gross fixed capital formation as a share of GDP in Estonia is forecast not to change much in the next few years. The acquisition of fixed assets in the economy as a whole will fall by 2.8% in 2013, but growth will recover in the coming years. As external demand improves, it can be expected that corporate investment will increase as the level of acquisition of fixed assets is low and interest rates support investment. The negative contribution of the general government sector to growth will recede in 2014 and 2015 and gross fixed capital formation will grow at 3.6% and 6.1% in the two years (see Figure 7).

Figure 7. Gross fixed capital formation



Sources: Statistics Estonia, Eesti Pank

Change in inventories

The contribution of change in inventories to real GDP growth remained small in 2012 and 2013. Growth in inventories slowed in 2012 and the change in inventories had an impact on GDP growth of -0.5 percentage points. However, inventories grew faster in 2013 than a year before, which meant that the change in inventories made a small positive contribution to GDP growth and the level of inventories increased as a share of GDP. The rapid growth in domestic consumption boosted the stocks of goods held for sale in retail and real estate companies while the stocks of finished goods of manufacturing companies also increased somewhat. It is forecast that the contribution of inventories to GDP growth will remain small in 2014 and 2015 and that inventories as a share of GDP will grow slightly from their level in 2013.

EXTERNAL BALANCE AND COMPETITIVENESS

In 2013 the Estonian current account continued to show a small deficit of around the same size as last year in terms of GDP. Lower external demand had a braking effect on exports of goods and services, and this worsened the external balance, although support came at the same time from the reduction in investment, which generally has a high import content. The negative impact of net exports will remain moderate for the coming years.

The negative impact of net exports in real terms on real GDP growth in 2013 will be down to -0.9 percentage points from -2.6 last year, and recovery in external demand in 2014 will help turn the impact of net exports positive. The strong growth in import-heavy investment in 2015 will make the impact of net exports on quarterly GDP growth negative, though this will not show up yet in the aggregate figures for the whole year.

Estonia's main trading partners in the first half of 2013 were Finland, Sweden, Russia and Latvia, and more than half of total Estonian exports went to those countries. The structure of Estonia's external trading partners by value added is described in more detail in Box 3.

The forecast expects that exports of goods and services at current prices will grow faster than imports throughout the whole forecast horizon. Terms of trade will remain favourable for Estonia as export prices rise somewhat faster than import prices. The forecast for Estonian export prices is based on the forecast for the prices of imports in the main target markets, and also takes account of the rapid rises in domestic prices, because, for example, the strong growth in wages in Estonia could partly be passed through into the prices of exported goods and services, harming competitiveness. Prices of Estonian exports have continually risen much faster than prices in export markets. The rapid rise in prices of exports stems from a shift in the structure of Estonian exports towards goods with higher value added, positive changes in the position in the outsourcing value chain, and the existence of niche products and markets. Rises in the prices of imports will be held down during the forecast horizon by relatively slow growth in prices of raw materials and a fall in the price of oil.

In the first nine months of 2013, the total of Estonian goods exports was slightly more than 1% smaller than in the same period of the previous year. This was mainly a consequence of a fall in export prices, as real export volumes of goods were around the same as a year earlier.

Exports of goods fell by about one tenth in the third quarter of 2013, with 72% of the fall coming from the decline in re-exports of motor fuels, where the amount of value added in Estonia is vanishingly small, as imports of motor fuels fell by almost the same amount. The impact of these motor fuels on the external balance is negligible, and such transactions are discluded from Estonian exports in the calculation of GDP. The flash estimate of GDP shows that exports of goods fell by only 2.5% in annual terms in the third quarter of 2013.

Although imports of goods declined in the third quarter of 2013, the decline was smaller than that in exports as domestic demand in Estonia grew faster and so did demand for imported products. Sluggish demand for capital goods and weak demand for inputs from the exporting sector together reduced imports. An important factor in the decline in the nominal value of imports was the fall in prices of imports caused by the fall in commodities prices. Preliminary estimates show that imports of goods increased at constant prices by 1% over the year in the third quarter of 2013.

The surplus on the services account in 2013 was smaller than in the previous year. Exports of services account for a little more than a quarter of total exports of goods and services. Preliminary estimates suggest that exports of services grew by 2.4% year on year in the third quarter, though the growth in imports of services was again stronger at an annual 4.9%, and the surplus on the services account continued to shrink. The decline in the surplus on the services account was smaller in the third quarter than the decline in the first half of the year, and for the first nine months of the year the surplus fell as a ratio to GDP by only 0.6 percentage points from a year earlier. The total contribution of net exports of goods and services to economic growth remained negative.

The forecast for the external balance is based on the assumption that growth in external demand will start to recover gradually, increasing Estonian exports of goods and services. In the last three years Estonian exports of goods have grown more than twice as fast as external demand, which is much more than in the preceding years. The forecast assumes that Estonian exports of goods and services will grow in the coming years at almost the same rate as external demand. Export growth is faster than growth in external demand by an amount that fits with the long-term difference in growth rates. The forecast for imports of goods is dependent on developments in domestic demand and exports. A small rise in the share of imports in total demand is expected during the forecast horizon in response to growth in investment and exports and faster rises in Estonian prices than in those in Estonia's trading partners.

The surplus in the account for current transfers for 2013 remained almost at its level for last year, and it contributed 1.4% of GDP to the current account surplus. It is forecast that European structural funds will play a smaller role in future, and this will be seen in a smaller surplus in current transfers in 2015.

Increased deficits in goods and services were offset by an improvement in the income account in 2013. The flash estimate of the balance of payments shows that the net outflow of income shrank again in the third quarter of 2013 mainly because of reductions in the income earned in Estonia by non-residents and in their investment position, which were affected by dividend payouts, loan repayments and the takeover of companies by Estonian residents. If the net outflow of reinvested income, which is a book value, is left out of the current account balance, the current account remained in surplus in relation to GDP in the first nine months of 2013, but by less than last year.

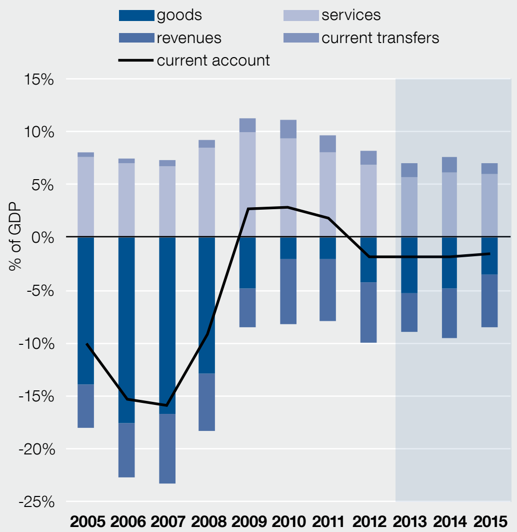
The forecast expects the income account deficit to increase in the coming years, mainly due to investment income. Non-residents continue to have larger investments in Estonia than Estonian residents have abroad, and the recovery in profits will deepen the income account deficit. The outflow of income will be smaller as a share of

GDP than it was in 2011-2012 during the forecast horizon due to the improved investment position and the convergence of the incomes earned by investments in Estonia and abroad.

The forecast expects the current account deficit to remain relatively small and to decline in 2015 to around 1.5% of GDP (see Figure 8). The deficit is much smaller than it was during the years of fast economic growth, and without the net outflow of reinvested income the current account will remain in surplus in the years covered by the forecast.

External debt will fall as a share of GDP during the forecast period. Estonia's gross external debt, which is the external debt of all the economic sectors in the country, will continue to increase in the coming years, but noticeably more slowly than nominal GDP. This means that the Estonian economy is growing out of its debt by deleveraging and by the end of the forecast horizon, external debt as a share of GDP will be smaller than it was before the boom years, and it will be less than 85% of GDP by the end of 2015.

Figure 8. Current account



Sources: Statistics Estonia, Eesti Pank

Box 3: The structure of Estonia's external trading partners by value added

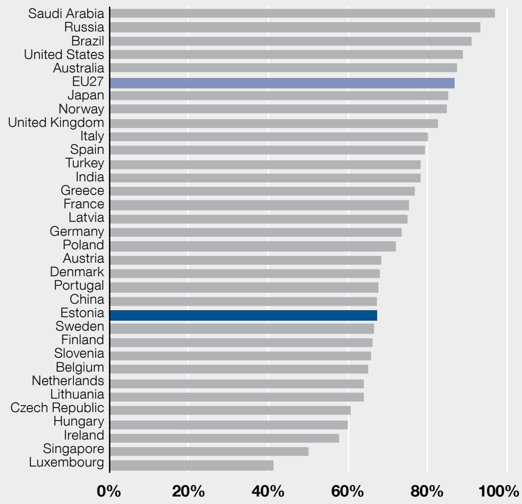
Modern production is fragmented internationally to a large extent and can be described as using global value chains or GVCs. Value chains cover a range of activities from the initial conception of a new idea to the delivery of the final product to the end-user, including project design, production, marketing, logistics, retail and post-sales customer service. All of this may be done by one single company, but the different tasks can equally be shared out among various companies. By expanding further, value chains are becoming ever more international. This has been encouraged by differing levels of technological development between countries, unequal access to resources and markets, and political treaties and reforms that have facilitated international trade.

Economies in the GVCs are ever more intertwined, specialising in particular activities within different stages of the value chain. A result of this is that there is a lot more intermediate consumption of goods and services within total trade than before. Intermediate consumption such as raw natural resources, various parts and components for goods, and semi-finished products today accounts for more than half of goods imports around the world, while services used in intermediate consumption such as business services or transport account for more than 70% of global imports of services[12]. However, exports often contain imported content and so the amount of domestic value added is that much less. Despite this, most analysis of foreign trade continues to use the simplified assumption that all exported goods and services are of equal importance for the national economy. This assumption is wide-spread because there is a lack of precise data on the imported content of various exported products, which would allow for a more accurate calculation of the value added in any country. Experts from the OECD and WTO have been working together with other international organisations in recent years on several studies that assess the domestic value added in the structure of exports, and that give an interesting picture of the structure of Estonian exports too.

Assessments using data from 2009[13] show that 67% of the value added in Estonian exports of goods and services was created in Estonia, and 33% of the content was imported. The amount of domestic value added in Estonian exports is lower than the average of 76% for the countries of the OECD but it is slightly higher than in Finland and Sweden (see Figure B3.1), though the amount of domestic value added in exports depends on the structure of production and is not directly comparable across countries. An example of this is Saudi Arabia where domestic value added makes up almost 100% of exports because the main product exported is oil.

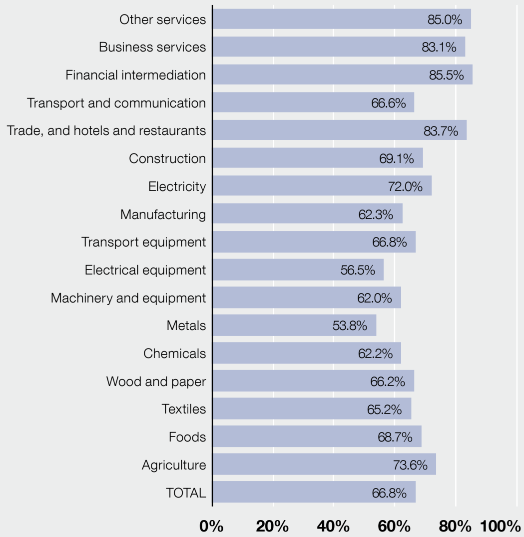
The product groups that had the lowest amount of domestic value added in the total value of exports were metal products, where

Figure B3.1. Total domestic value added share of gross exports in 2009



Source: OECD TiVA database

Figur B3.2. Total domestic value added share of gross exports in 2009



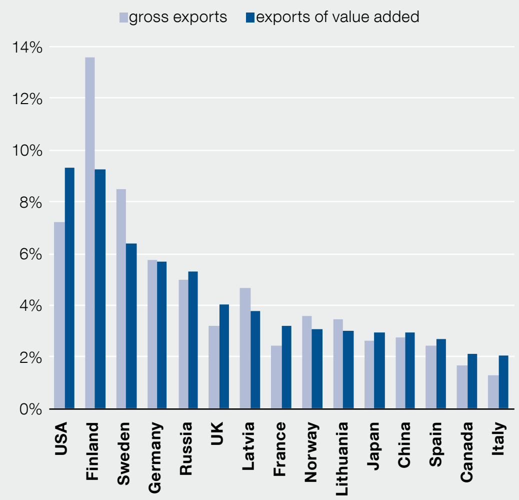
Source: OECD TiVA database

12 http://www.ecb.europa.eu/home/pdf/research/compnet/OECD_2013.pdf.

13 http://www.oecd.org/sti/ind/TiVA_ESTONIA_MAY_2013.pdf.

domestic value added was 54%, and electrical equipment, where it was 56%. Other products from the manufacturing sector had a share of domestic content that was around two thirds, and the highest share was in the exports of services (see Figure B3.2). In 2009 exports of services made up over 50% of total Estonian exports by value added. This was slightly more than the OECD average of 48%, reflecting their relatively high importance for Estonia in earnings from exports.

Figure B3.3. Partner shares in gross exports and exports of value added in 2009



Source: OECD TiVA database

Because the share of domestic value added varies across different products, the distributions of Estonian exports between destination countries by total value and by value added are different. Finland was the top export destination by total value for Estonia in 2009, taking 14% of exports of goods and services[14], but the USA was the most important export destination by the content of domestic value added, receiving 9% of all the domestic value added contained in Estonian exports. The importance of Finland as an export market is slightly lower in this case (see Figure B3.3). This shows how integrated the value chain is, as a major part of the value added created in Estonia reaches the markets of the USA through exports from Finland and Sweden in the part of the final cost that was imported from Estonia.

14 http://www.oecd.org/sti/ind/TiVA_ESTONIA_MAY_2013.pdf.

THE LABOUR MARKET

As growth in the economy slowed in the first half of 2013, imbalances increased in the labour market. Labour costs grew faster, driven by both short-term factors and long-term changes like the ageing of the population and emigration, which increased labour shortages.

The growth in employment in the first half of 2013 was an exceptional effect, and in future employment will decrease gradually together with the working age population. The employment rate will continue to rise however, and will reach 63.5% by the end of the forecast horizon, close to its pre-crisis peak.

Wage growth will slow somewhat in 2014, though rises in productivity will keep it high throughout the forecast period. A recovery in external demand will let companies make more effective use of their labour resources and this will help them to maintain balance between wages and productivity. The wage fund will be almost 2.5 percentage points larger as a share of GDP in the coming years than its annual average of 2002–2005, the years before the boom, reflecting structural changes in the economy that have favoured employees.

Employment

Total employment grew in the first three quarters of 2013 by 1.9% in annual terms. The estimates of employment growth for 2013 in the labour force survey do not take account of migration or the natural decrease in the working age population. If those factors are included, the growth in employment in 2013 is seen to have been overestimated by around 1.3 percentage points. Other sources of data for changes in employment, such as the data from the Tax and Customs Board on recipients of wage payments or from the financial data of enterprises show that growth in employment has been stably slowing over a long period.

The number of residents working abroad fell in annual terms during the first three quarters, meaning that the employment in production units resident in Estonia grew faster at 2.3% than total employment. The number of cross-border employees shrank either because their country of work became their country of permanent residence, or because of the economic slowdown in the Nordic countries. It is forecast that the share of residents working abroad in total employment will not change in the coming years and will remain at the level of 2013.

Employment growth was broadly based across activities. In 2012 it was industries focused on the domestic market that supported employment growth, but in the first nine months of 2013 manufacturing also made a positive contribution to it. Data from the wage survey, enterprise statistics and the Tax and Customs Board all indicate that employment grew quite stably in manufacturing from the start of 2012 at around 3% a year.

It is assumed that demand for Estonian exports will remain low in 2013 and a steady improvement in demand is expected in subsequent years. As companies adjust their labour inputs to reflect the fall in demand with a lag of around half a year, the outlook is for weak employment growth in 2014. The ability of manufacturing companies to recruit and hold on to employees will start to be limited by the rapid rise in wages in industries that do not face foreign competition and can therefore pass wage costs more easily on into end prices for products.

The outlook for the coming years is not promising in construction either. Investments by the government sector will be smaller in both 2014 and 2015 than in the recent past, meaning that demand will fall for many construction companies. This fall in demand will be partially offset by a recovery in the real estate market backed by low interest rates. The labour share of value added increased in the construction sector in 2013 significantly, which suggests there is pressure to reduce labour costs. Construction surveys have reflected the increasing pessimism of companies about the outlook for employment in the construction sector throughout 2013.

Employment in the service sector, which is not affected very much by weak external demand or low investment, grew in the first three quarters of 2013 at around the same pace as in 2012. This was aided by an increased willingness to consume among households, which was itself encouraged by a favourable labour market and a rapid rise in incomes. Service sector confidence surveys show that the employment expectations of service companies in the private sector are more optimistic than those of other industries.

The estimates of the labour force survey show that employment fell in the public sector in 2013, while data from the Tax and Customs Board show that the number of wage recipients registered as working for government institutions has fallen for two years in a row. Given the rapid wage growth in the private sector and the limits placed on growth in the government sector wage fund by consolidation of the budget, employment in the government sector is unlikely to increase in the coming years.

In 2013, as in 2012, the hours worked per employee fell and the share of employees working part-time increased. This is partly because labour inputs have adjusted to the temporary fall in demand, but there are several indications that the reduction in working hours could in part be a long-term development. These are that working and rest time rules have been tightened in recent years, the employment rate for older people has increased, and the number of people underemployed has declined. The growing share in the total working population of the over-50s, who are more likely to work part time, pushes the average hours worked per employee downwards. The forecast expects that working hours per employee will rebound somewhat as economic activity increases, but will remain noticeably lower than before the crisis.

On top of the recovery in employment, emigration and the natural decline in the working age population are also causing tension in the Estonian labour market. This forecast does not take full account of this because the labour market and population data will only be corrected using the results of the population census of 2011 in time for the forecast of June 2014. Nevertheless, employment will fall in both 2014 and 2015, but the employment rate will rise slightly (see Figure 9).

Weak economic growth in 2013 will lead to an adjustment in employment in 2014, when it will fall by 0.4% in resident production units. Economic growth will pick up again in 2015, but employment will continue to decline under the impact of population changes and the change in employment will be -0.3%.

Figure 9. Labour force, employment and hours worked

Sources: Statistics Estonia, Eesti Pank

Unemployment

The unemployment rate had fallen to 8% by the third quarter of 2013 as employment growth proved faster than expected. This means that the unemployment rate had dropped 1.7 percentage points in a year. In seasonally adjusted terms, the unemployment rate rose from 8.1% in the second quarter to 8.6% in the third quarter. As unit labour costs rose in the first half of 2013 and wage growth accelerated, the unemployment rate is probably below the NAWRU[15]. This means that there is a shortage of qualified labour available and employers are having to raise wages in order to recruit new employees and keep their current ones.

Unemployment fell in the first three quarters of 2013, as it did in 2012, through falls in the numbers of both the short-term and the long-term unemployed. The share of the unemployed who were long-term unemployed fell in the third quarter to 42.6%. The labour force participation rate rose however, and the number who were discouraged remained low, which means that the decrease in the number of long-term unemployed was not predominantly due to them leaving the labour force. The decline in unem-

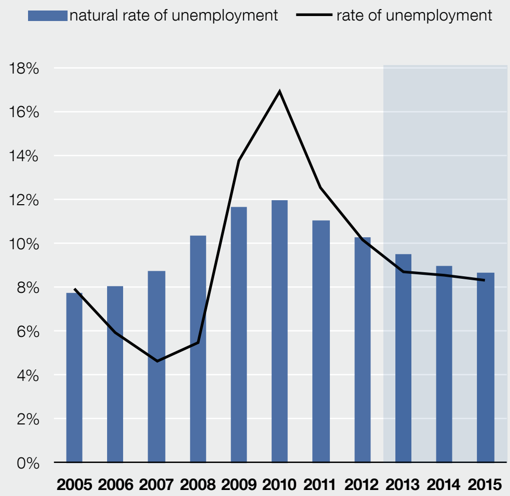
15 The NAWRU (*non-accelerating wage rate of unemployment*) is the level of unemployment where wage rises do not increase wage pressure on the economy.

ployment was quite even across age groups and the unemployment rate fell most among those aged 50-74.

Data from October on the registered unemployed and the number of recipients of wage income permit the forecast that the unemployment rate for the fourth quarter will be around 8.5%, which would be slightly higher than in the third quarter in seasonally adjusted terms. Unemployment will fall slowly in 2014 and 2015 and by the end of the forecast horizon the unemployment rate will stand at 8.3% (see Figure 10).

The recovery in the labour market will also be affected by the slow but constant decline in the NAWRU and in structural unemployment. This forecast is largely backed up by ongoing retraining for the unemployed and active labour market measures, for which funding per unemployed person has increased in recent years. The fall in structural unemployment will ease the labour shortages and reduce wage pressures, and this will make it easier to hire new employees.

Figure 10. Unemployment



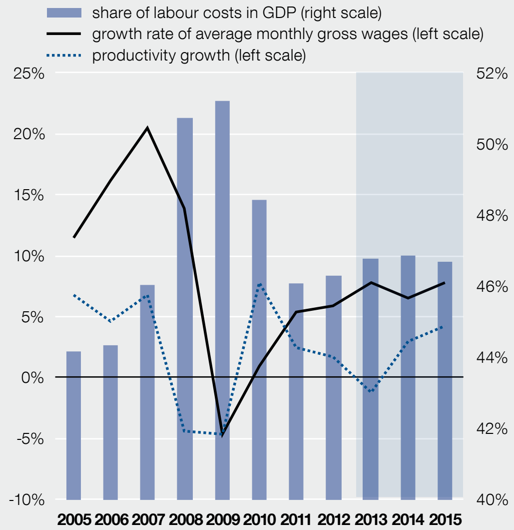
Sources: Statistics Estonia, Eesti Pank

Wages and labour costs

Average wage growth accelerated in the first three quarters of 2013 from 5.9% in 2012 to 7.9% even as the economy grew more slowly. Tax and Customs Board data on the average wage income paid out indicate that rapid wage growth has continued into the fourth quarter of 2013.

Wage pressure increased because of several factors in the first three quarters of 2013, including the rise in the minimum wage and collective pay agreements in both the public and private sectors. However, these factors are not able to explain a large part of the rise in wages. The most important factor was the shortage of labour caused by the decline in labour resources, which then strengthened the hand of employees in pay negotiations (see Box 4 for details).

Figure 11. Wages and productivity



Sources: Statistics Estonia, Eesti Pank

Wage growth is forecast to remain strong in Estonia in the coming years, reaching 6.6% in 2014 and 7.7% in 2015 (see Figure 11). This will be partly a consequence of improved productivity, though at the same time the causes of the wage pressures will not ease. The minimum wage will rise by around 10% in each of the next two years, and the government sector payroll will continue to increase by around 6% a year.

The growth in unit labour costs accelerated in the first three quarters of 2013 to 6.2% and overall labour costs, or the payroll as a share of GDP, were 2.6 percentage points higher than the average for 2004-2006. Although unit labour costs will stop growing, no significant reduction is foreseeable for 2014 or 2015 as the shift in the position of the employee is a permanent one.

Box 4: Factors affecting wage growth in 2013

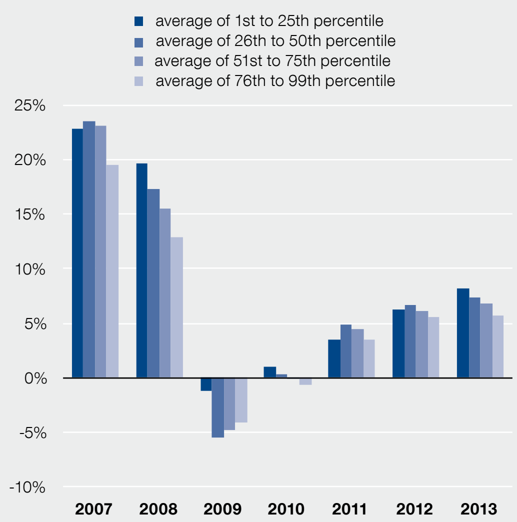
Wage growth accelerated in the first three quarters of 2013 to 7.7% even as the economy grew more slowly. This box will look at the factors behind the faster wage growth, considering how much the increase in the minimum wage and the pay rises in the public sector contributed, and how much impact there was from the shortage of labour.

Wages in the public sector are partly driven by political decisions and partly by collective agreements, which play a larger role than they do in the private sector. As the public sector is competing with the private sector for labour resources, the growth rate of the average wage in the public sector cannot differ too much from that in the private sector for very long, and data from wage surveys show that public-sector wages follow those in the private sector with a lag. Wage statistics show that wage rises in state-owned entities accelerated from 6.2% in 2012 to 7.6% in the first three quarters of 2013, and in local government entities rises increased from 2.9% to 7.7%. Various factors are behind this, such as the acceleration of wage growth in education from 3.1% to 8.1%, and in health and social work from 4.8% to 7.5%.

Wage data alone are not enough to give the contribution of the public sector to the rise in average wages, and data on the number of people employed are also needed. Unfortunately, the number of full time equivalent employees is not published by type of employer, so the Tax and Customs Board data on wages received are used instead. Although the increases in the average wage and in the average wage paid out are similar in the longer term, they are not always the same when viewed by quarter. The growth in the average wage paid out accelerated in the first three quarters of 2013 on average from 5.9% to 6.4%. There were 2.1% fewer recipients of wages in the first three quarters of 2013 in the register for government institutions and the growth in the average wage paid to them increased from 4.3% in 2012 to 8%. The contribution of the public sector to the growth in the average wage paid for the economy as a whole increased from 0.4 percentage points to 1 percentage point, and this means that the acceleration in the growth in the average wage in 2013 can largely be explained by the acceleration of wage growth in the public sector.

A second factor that could be causing acceleration in the growth of average wages is the raising of the minimum wage. The minimum wage was raised in 2013 by 10.3% and increases of 35 euros have been agreed for the next two years, equal to 10.9% in 2014 and 9.9% in 2015. If the rise in wages in the first three deciles of the wage distribution is fully attributed to the rise in the minimum wage, then the minimum wage has had an impact of 0.5 percentage points on the rise in wages paid out in 2013. However, wages at the lower tail of the distribution rise similarly to those in the rest of the economy due to increased productivity and the changes in demand and supply for labour, so this calculation should be taken as an upper limit. A lower bound can be calculated by attributing the difference in growth rates between the lower and higher deciles to the minimum wage increase, and in this case the impact of the minimum wage is calculated at 0.1 percentage points. This impact is small because the agreed rises in the minimum wage are close to the expected rise in the average wage across the economy, and this is evidenced by the strong correlation with the known wage growth during the current year at the time of the negotiations. In 2013 the growth in the minimum wage outstripped that in wages in the economy as a whole and the fastest growth in average wages paid out was in the lower tail of the distribution (see Figure B4.1).

Figure B4.1. Average growth rate of taxed wage receipt percentiles



Sources: Estonian Tax and Customs Board, Eesti Pank

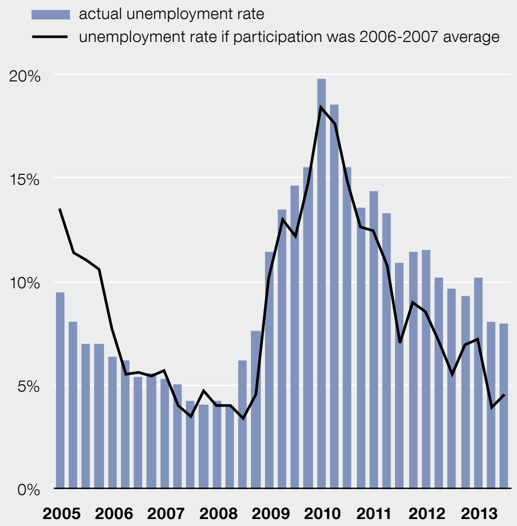
The acceleration in wage growth in the public sector and the rise in the minimum wage have helped to boost wage growth that was already rapid. Wage growth has been strong due to an increase in the productivity of the exporting sector, though the shortage of qualified labour has also had an effect.

Several indicators point to a shortage of labour, including a fall in the number of unemployed per vacancy[16] and a rise in the importance of labour shortages as a factor restricting production[17]. Although the unemployment rate is almost double what it was before the crisis, the employment rate, which shows the share of the working-age population that is employed, is near to its all-time peak. The labour force participation rate has also risen, and this means that additional people have entered the labour market who would probably have been inactive in the past because they were discouraged, ill or looking after family members. There is now more incentive for people to participate in the labour market and register as unemployed than there was before the crisis, as health insurance has been extended to all the registered unemployed; labour market services from Töötukassa, the unemployment insurance fund, have improved

16 Data from Statistics Estonia.

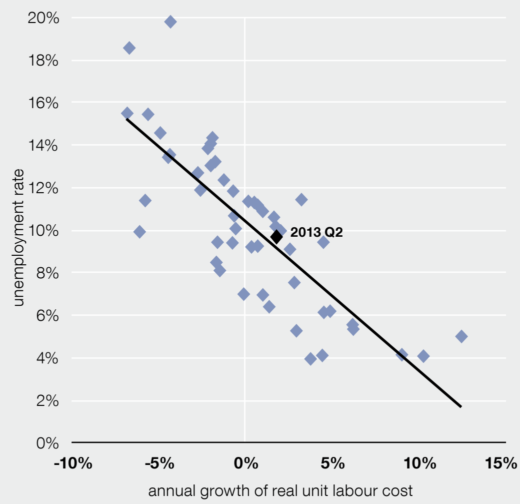
17 Barometer survey of the Estonian Institute of Economic Research.

Figure B4.2. Actual unemployment rate and hypothetical unemployment rate if participation were at its average



Sources: Statistics Estonia, Eesti Pank calculations

Figure B4.3. Unemployment rate and real unit labour cost growth, 2001-2013 Q2



Sources: Statistics Estonia, Eesti Pank

and unemployment benefits have been increased. In consequence it is probable that among the unemployed there are currently more people than before who are struggling to find a job because they lack qualifications and skills or have been unemployed for a long time. The rise in the participation rate means that the unemployment rate gives a more optimistic picture of the labour force reserves than was the case before the crisis. If the labour force participation rate were as low as in 2006-2007, the unemployment rate in the third quarter of 2013 would have been 4.6% rather than 8% (see Figure B4.2).

The shortage of labour with the right qualifications has strengthened the position of employees in wage negotiations, and they have succeeded in increasing the share they receive of the value added created. Figure B4.3 shows the relation between the shortage of labour and the increase in wage costs since 2001. When unemployment has been high and available labour resources relatively plentiful, the growth in real unit labour costs has been negative and the payroll has declined as a share of GDP. When unemployment has been low, in contrast, wage costs have increased as a share of value added, meaning that companies have had to reduce their profit margins in order to hang on to their employees and recruit new ones. This has also happened in 2013, although the pressure on wages to rise was weaker than during the boom years.

INFLATION

Inflation continued to fall in Estonia in 2013, but it remained higher than in the other countries of the euro area, reaching 3.8% during the first half of the year before dropping sharply in the third quarter. The fall in inflation was broad-based and was seen in energy and food prices and in core inflation. The main cause was the reduction in inflationary pressures in the external environment, which was passed through into Estonian prices through imports. Global crude oil prices fell in euro terms in 2013 for the first time in three years and the prices of other raw materials also fell somewhat, though the low level of inflation in the external environment is seen as a temporary phenomenon. The growth of close to zero in 2013 in the import deflator will pick up to 1.1% in 2014 as global economic activity increases.

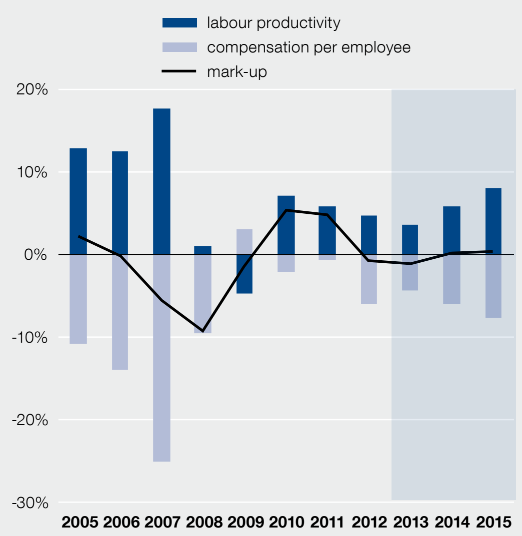
The main sources of domestic price pressures are unit labour costs, company profit margins and taxes. Profit margins grew strongly in 2010-2011 after the economic crisis, but then they started to fall again as wages and employment grew rapidly while economic growth slowed. Companies were able to pass a part of the increase in costs on into prices, with the result that growth in the GDP deflator has accelerated in 2013 to 4.5% (see Figure 12). Growth in unit labour costs is forecast to slow in 2014 to 3% and the faster growth in labour productivity will partially offset the inflationary pressures coming from the labour market. The consequence will be that the reduction in profit margins will cease within the forecast horizon (see Figure 13).

Growth in the harmonised index of consumer prices (HICP) was fairly fast in Estonia in 2013 at around 3.3%, but it is forecast to slow to 2.3% in 2014 (see Figure 14). Inflation will fall to an unusually low level in the first half of 2014 and will be close to two percent as the effect of the high reference base that resulted from the opening of the electricity market disappears. In the second

Figure 12. Composition of the GDP deflator growth

Sources: Statistics Estonia, Eesti Pank

Figure 13. Contributions to mark-up growth



Sources: Statistics Estonia, Eesti Pank

half of the year inflation will again pick up somewhat. The forecast expects that inflation will reach 3.0% in 2015 in response to higher prices in both the external and domestic environments.

Food

Food price inflation was relatively fast in the first half of 2013 in Estonia, with vegetable prices rising by around 20%. The rapid rise in the prices of horticultural products in the summer months was not typical of the season, but there was a sharp downward correction in the autumn. Food price inflation will continue to fall in 2014, mainly due to the slowing of rises in prices for unprocessed food products. This should be helped to an extent by lower global grain prices than a year earlier following better weather and larger harvests than before. Inflation will be low in the prices of processed foods in the first half of 2014, after which inflation will accelerate.

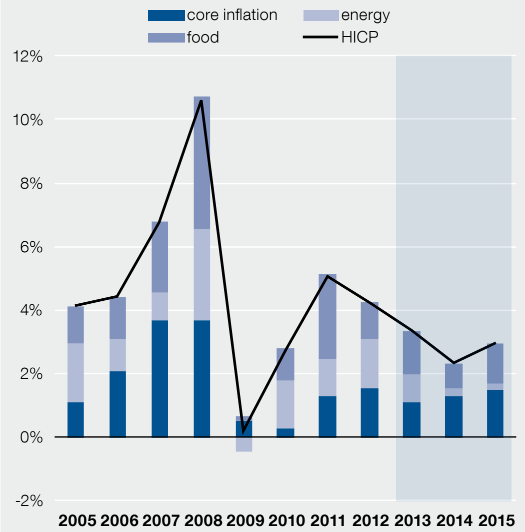
Alcohol and tobacco products will continue to increase in price throughout the forecast horizon due to tax changes. Rises in the excise on alcohol will raise inflation by 0.2 percentage points each year and tobacco excise will be raised at the start of 2014, adding 0.1 percentage points to inflation. Stocks held by companies mean that the effect of this will probably be passed into the consumer price index in February, though it might not be until April.

Energy

The main cause of the fall in inflation both in the euro area and in Estonia has been the decline in global prices for imported energy. This has been aided by the appreciation of the euro. The fall in global prices for sources of energy is likely to be temporary and could change suddenly if global economic activity increases.

Energy prices fell in the majority of euro area countries in the second half of 2013, but they

Figure 14. HICP growth



Sources: Statistics Estonia, Eesti Pank

continued to rise relatively fast in Estonia, with annual increases reaching 5%. This was due to the opening of the electricity market at the start of the year, which saw electricity prices for households rise by more than 25%. Higher electricity prices had a major impact on inflation, boosting it by around one percentage point in 2013. Markets expect that the average price of electricity for a year will remain fairly stable throughout the forecast horizon. New electricity cables to the Nordic countries will cover the lack of electricity generating capacity in the Baltic states to some extent, and will reduce the risk of price rises in the region.

In the second half of 2013, prices for motor fuels, heating energy and natural gas also fell. Changes in the prices of heating energy and natural gas products reflect movements in the oil price, though they usually show up in the consumer price index with a lag of more than half a year. Forecasting of inflation in heating prices is somewhat complicated by the diversity of heat prices across regions and also by the need for investment, which could induce unexpected price increases. The price of heat may also fall in some regions of Estonia during the forecast horizon as alternative sources of energy start to be used.

Core inflation

Core inflation covers the inflation in the prices of industrial goods and services that are largely dependent on domestic factors. Inflation in prices for services was dampened in 2013 by several temporary factors and administrative measures. Public transport became free for residents of Tallinn in January and so the price of public transport fell by 10% in one month, slowing the rise in the consumer price index by 0.2 percentage points. A higher education reform was implemented in September that lowered the cost of education services by 16%. Another free service was added in November with local rail transport around Tallinn. Without these effects, services inflation and thus consumer price inflation overall would have been around 0.5 percentage points higher in 2013. The impact of free services will steadily pass out from the inflation rate during 2014.

Services inflation has also been dampened in Estonia in the last three years by the fall in prices for communication, which has been among the largest in the European Union. Cheaper communications cut 0.5 percentage points off the inflation rate for 2013. Communications companies have indicated that the rapid fall in prices for communications services may end soon, increasing services inflation. Services inflation will return to its long-term rate at the end of 2014 due to wage growth pass-through, and is expected to reach 3.5-4% in the coming years.

Inflation in the prices of industrial goods, the other component of core inflation, will be low at under two percent throughout the forecast horizon, as it has been in previous years. The slow growth rate in the prices of imports will offset the impact of wage growth and the addition of extra retail space will increase competition in the domestic marketplace.

GENERAL GOVERNMENT

Although the fiscal position of the Estonian general government is better than those of many other European countries, the improvement since the crisis has not been smooth. The impact of temporary income that the government gained by stopping payments to the second pillar of the pension system during the crisis years has now ended and the deficit-increasing consequences of those decisions prevail. Income from sales of emissions quotas[18] has fallen to a very low level and projects that were funded from earlier sales are now pushing up government spending. The result is that the nominal budget position is noticeably worse for the forecast period than in, say, 2011 when there was a surplus of 1.1%. It is forecast that budgetary expenditure will continue to exceed revenue throughout the forecast horizon. The budget will return to close to nominal balance in 2015, but that will mainly be due to the positive impact of the economic cycle on tax income. The forecast expects the structural surplus to be maintained in 2013-2015.

Budget revenue

As it did last year, the structure of the economy encouraged healthy tax receipts in 2013. Wage growth was strong in 2013 and receipts from taxes on labour grew faster than the economy as a whole even though the unemployment insurance rate was lowered at the start of the year. Private consumption rose together with the incomes of residents, but problems in collecting taxes led to a fall in the effective tax rates for VAT and excise taxes despite a rise in excise on alcohol and tobacco. Receipts from corporate income tax were notably high in both 2012 and 2013, but in 2013 dividends were primarily taken

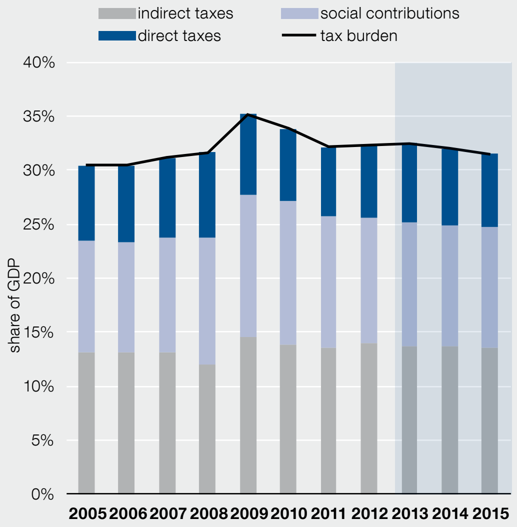
18 As used in the trading system based on the Kyoto Protocol.

in the private sector. Initial estimates show that tax income to the general government grew by 6% in 2013, and the total tax burden remained at 32.5% of GDP (see Figure 15).

The tax burden will decrease in 2014 and 2015 and will reach its level of prior to the crisis, which has been targeted by the government. Tax income will be reduced from 2014 in accounting terms by additional payments to the second pension pillar as the government will temporarily increase its own contribution to the mandatory funded pension by transferring part of the social tax collected for pension insurance. One of the government's strategic goals is to reduce taxes on labour, so it will cut the income tax rate from 21% to 20% in 2015. At the same time excise on alcohol and tobacco will continue to rise.

The share of non-tax revenue in the general government budget will fall as the transfers from the budget of the European Union are reduced. As a result, both capital transfers and current transfers to the general government will be smaller. The new budget period for the European Union will start in 2014, though experience has shown that the major deployment of financing from the Structural Funds will only start a couple of years after the new budget period starts. Current income has fallen in 2013 as dividend payments have been postponed into the next financial year.

Figure 15. Tax burden



Sources: Statistics Estonia, Eesti Pank

Budget expenditure

General government capital spending will remain lower in the years of the forecast than it was in 2012, when spending was boosted by the large scale of the projects funded from the sales income from emissions quotas. These quota-funded investments will continue until 2015 but will be much smaller than in previous years. This is the main reason why government investment has stopped growing in 2013. General government capital spending will also be restricted in 2014 and 2015 by the low levels of external transfers. The peak period for using EU funds was in 2011 and 2012, when the government was able to reinvigorate the economy without increasing the budget deficit. Net income from the European Union in 2012 was worth 4% of Estonian GDP and this is forecast to fall to 2.5% by 2015.

Boosted temporarily by the quota-funded investments, general government spending grew by more than tax income did in 2012, but growth was much slower in government wage costs and administrative operating costs. The impact of one-off expenses will fade during the forecast horizon, but the growth rate of labour and consumption costs will increase. Wage pressures in the general government sector will be increased by the wage agreements that have already been adopted for some professions and by faster wage growth in the private sector. The government is also planning to increase the share of social costs in the 2014 budget. The result of this is that current spending will continue to grow slightly faster than tax receipts in the coming years and the plan in the budget strategy of achieving nominal budget balance by 2014 will be postponed.

Fiscal balance and debt

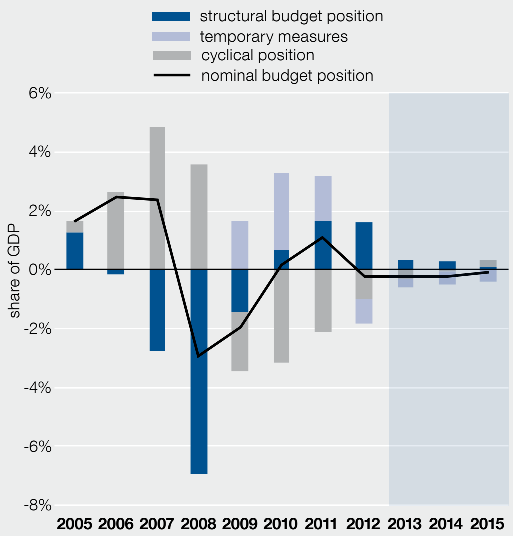
The nominal budget deficit of the Estonian general government as a ratio to GDP will probably not fall in 2013 and will remain at 0.2%, where it was in 2012. The deficit was enhanced in 2012 by one-off spending on investments, which will have less of an effect in 2013, and in 2013 non-tax income will fall as a share of GDP. The economic cycle will continue to have a negative impact on budget revenues and the structural surplus will be 0.3% of GDP. As tax receipts will grow faster than their long-term trend in the years covered by the forecast, the impact of the economic cycle on the tax base will turn positive by 2015 and the structural surplus will fall to close to zero.

Although the nominal budget deficit will decrease during the forecast horizon, a balanced budget will not be achieved by 2015 if fiscal and macroeconomic assumptions do not alter (see Figure 16). In the budget strategy that was published in spring 2013, the government set the target of keeping the structural fiscal position in surplus and replenishing reserves. The interim targets under the strategy for the recovery of reserves are a nominally balanced budget in 2014 and a surplus from 2015 onwards. When the 2014 state budget was planned, the main target was to keep a 0.7% structural surplus, while the aim of a nominally balanced budget was pushed a year further back.

There is a risk in excessive focus on structural indicators as a sustainable fiscal policy and a build up of reserves also requires attention to be paid to nominal figures. Assessments of the economic cycle and therefore of structural balance are always prone to inaccuracy. During the boom years, various methodologies overestimated the potential growth of the Estonian economy, meaning that structural deficits were estimated to be smaller than they actually were. It should also be remembered for the current forecast period that wages rose very fast in 2013 and tax income growth will exceed the long-term average during the forecast horizon.

The general government debt will remain very low throughout the forecast horizon and will stay close to 10% of GDP. Financing operations and loan guarantees to the European Financial Stability Facility (EFSF) will have more of an impact on the level of debt than will the funding of the budget deficit.

Figure 16. General government budget position



Sources: Statistics Estonia, Eesti Pank

THE BANKING SECTOR AND THE FINANCING OF THE ECONOMY

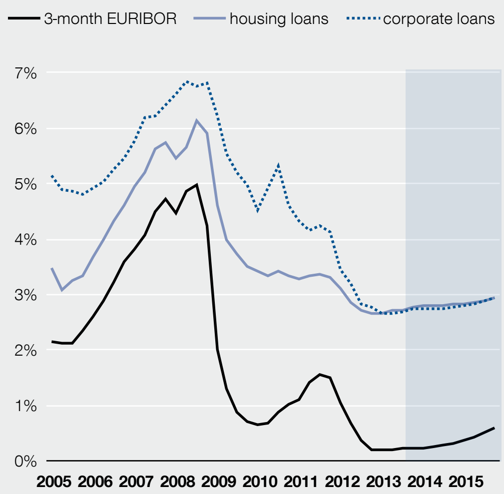
Lending

Lending in Estonia is supported by the good financial standing of the local banks and the relatively fast growth in deposits from the non-financial sector, which stood at 5% in the third quarter of 2013. Growth in domestic savings meant that banks had less need to get funds from their parent banks, and the funding of the loan portfolio is mainly underpinned by savings. The financing risks to the Estonian economy have been partially alleviated by the high capitalisation levels and liquidity of the parent banks in the Nordic countries, which can let them access funds from the markets on good terms if necessary. The loan to deposit ratio of the banking sector, which had fallen noticeably after the crisis, has been at 109% in recent months. Deposits from the non-financial sector increased by slightly less than was expected by the June forecast, but the growth should speed up moderately during the forecast horizon. Corporate deposits have stopped growing this year, but this is partly due to the decisions of certain larger companies. In future deposits will start to increase again and growth in household deposits will be supported by the relatively rapid recovery of incomes.

Interest rates will remain low in the coming years. The interest rates on loans granted to the non-financial sector have in general been as was forecast in June. EURIBOR, the inter-bank money market rate which also serves as the base rate for most loan contracts, stabilised at the start of 2013 at a very low level. Although it is assumed that EURIBOR will start to rise slowly in 2014, it will still remain low by historical standards throughout the forecast horizon.

There will be no major change in interest margins in the short term outlook. Competition between banks for new borrowers is relatively moderate despite their good capitalisation and funding. The very low interest rates mean that banks have had to keep their margins fairly high to maintain profitability. However, loan margins will decline slowly in the second half of the forecast horizon thanks to a general reduction in uncertainty, the dissipation of the impact of earlier loan losses, and a rise in base interest rates (see Figure 17).

Figure 17. Lending rates



Sources: Eesti Pank, European Central Bank

Credit demand

Demand for loans will increase in line with economic growth but at a slower pace than the economy. Slow growth in the economy has meant that growth in lending volumes has been slower than was forecast in June. The moderate growth that had been seen for about a year in the loan and lease portfolio of the non-financial sector slowed in spring 2013 and stood at 1.3% by the end of the third quarter. Loan volumes grew more moderately than was forecast partly because of one-off factors like the closure of the

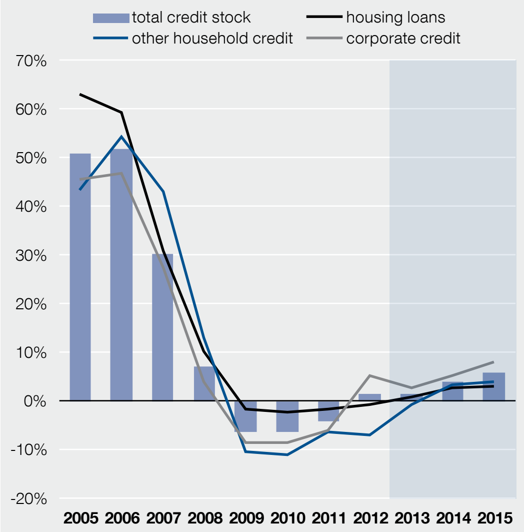
Estonian branch of UniCredit and the reclassification of some non-financial sector companies as financial sector companies. The loan portfolio will continue to grow at a slower rate than nominal GDP throughout the forecast period, meaning that deleveraging in the economy will continue.

Corporate loan demand has mostly been held back in 2013 by the low growth in investment in fixed assets. Growth in corporate loans granted has slowed in most industries since spring 2013 though it has been boosted in recent months by major refinancing operations in several sectors of the economy. As economic and investment activity increase, it is expected that the volume of loans taken from the domestic banking sector will also increase. Although no increase in the volume of credit-intensive real estate development is expected in the short term, the continued rise in real estate prices may well favour such an increase in the longer term.

Companies are borrowing increasingly from abroad. The role of domestic financial markets outside the domestic banking sector in financing companies has remained very modest since Estonia regained its independence. Borrowing from banks based abroad and volumes of bonds issued abroad have, however, increased significantly in the past five years, and by the end of the second quarter of 2013 external debts made up more than 35% of the total debt burden. It is mainly large and foreign-owned companies that are able to borrow abroad, while smaller companies can finance their activities either through the domestic banking sector or by using internal funds. This means that the support of the banking sector is important for further growth in investment.

Although household demand for credit is increasing steadily, growth in the loan stock remains modest. In the third quarter of 2013, households took out 8% more loans and leases than a year earlier with the turnover of housing loans increasing by 19% and that of other loans to households by 1%. Demand for new housing loans is being supported by increasing incomes, very low interest rates and demographic changes[19], meaning that household credit demand will probably continue to increase in the years to come. This demand may also be affected by expectations that the relatively rapid rise in real estate prices will continue. As the loan stock is relatively high as a share of GDP and old loans are being repaid, growth in the loan stock will remain modest in future at the forecast levels of turnover (see Figure 18).

Figure 18. Credit stock growth



Source: Eesti Pank

Real estate prices have risen faster than incomes this year. The number of sales transactions for apartments was 14% higher in the third quarter of 2013 than it was a year earlier, and the average square metre price for an apartment was 9%

19 Despite the decline in the population due to negative population growth and emigration, the number of potential buyers will increase because the large generation born at the end of the 1980s is now entering the real estate market.

higher. The demand for new, high-quality and well-situated residential space will remain relatively high, but the number of offers for sale has fallen. Several developers are working on projects that could not earlier be brought to market because of uncertainty surrounding sales prices. Although the growth in real estate prices and incomes should converge in the long term, the real estate market could also overreact in anticipation of continued rapid price rises. It is important that the role of banks in financing real estate transactions does not become too large.

RISKS TO THE FORECAST

The risks associated with economic growth in the next two years are mainly on the downside. The risks stemming from the external environment are noticeably smaller than they were half a year ago, but demand for Estonian exports could still turn out to be weaker than assumed, with the result that Estonian economic growth could prove lower than forecast and the strong recovery in growth could be delayed. Although growth has returned to the euro area economy, its sustainability is dependent on a recovery in capital formation, particularly corporate investment in fixed assets, which has fallen appreciably since the crisis. For investment activity to recover, it is important that companies have access to funding from bank lending, but this may be complicated in several euro area countries where banks need to improve their own balance sheets at the same time, which could lead them to limit the supply of credit.

The risk of rapid wage growth and higher production costs that was identified in the June forecast was partially realised in 2013. The impact of this on corporate activity was amplified in the first half of the year when the economy stopped growing, as the gap between wages and productivity became wider and profit margins fell. Companies that are focused on the domestic market have thus far managed to cover their rapidly rising wage costs with price rises, but export-oriented industries cannot do this because competition from abroad is tough. As no let-up in wage growth is expected in the near future, the risk remains that wage pressures will start to have even more of an impact on the exporting sector. To keep up with the pressures for wage rises in the domestically oriented sector, exporting companies will have to control their labour costs by reducing their numbers of employees in order to maintain profitability and their price competitiveness. The consequence of this would be an increase in unemployment in the short term.

Rapid wage growth and consistently low interest rates mean that the risk remains of excessively fast rises in real estate prices. The share of house purchases financed with own funds has increased in recent years significantly in comparison to the share financed with bank loans, so it only needs a fairly moderate increase in borrowing activity to push the growth in property prices up from its already high level.

The risks to inflation are more on the upside. Core inflation has been restrained by the fall in prices for communications, which has lasted for some years but may now have ended or be about to end. It is also possible that the recovery in the economies of Estonia's trading partners could lead to an acceleration of price rises for imported goods. Weak global demand has held the prices of commodities down and led to expectations of a fall in the global oil price but if demand for commodities rises faster than expected it could drive prices up, and this would be reflected in Estonian consumer prices.