Eesti Pank

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ECONOMIC FORECAST 2014-2016

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 assumptions are based on information available as at 20.05.2014, and the Estonian economic data available as at 14.05.2014.

SUMMARY

Growth slowed in the Estonian economy in 2013 and the expected recovery did not occur at the start of 2014. The flash estimate shows that GDP shrank in the first quarter of 2014, which was the result of a fall in value added in certain sectors, as it was in the previous year. Although the rate of growth has declined steadily over the past three years, this has not yet had a significant negative effect on households or on the national budget. Wage rises have remained high in the labour market, and household incomes and consumption have increased rapidly. Tax revenues have consequently been good and this has given support to the national finances. However, the increase in the nominal size of the economy has mainly been led by production costs and product prices in recent years, but this is no longer possible to the same extent. For the Estonian economy to continue developing, the state finances to remain good and household incomes to continue rising, real growth in the economy needs to accelerate.

The general trend in global economic activity is one of growth, despite the temporary weakness at the start of the year, and the trend is expected to continue in the coming years. Advanced economies are relatively strong, but growth is hindered in emerging markets by weak domestic demand and imbalances in many countries. Growth has recovered at the expected rate in the euro area as a whole, but has picked up less quickly than had been hoped in several main destination markets of Estonian exports, where it will remain sluggish in the coming years. The possibility that there will be unexpected developments in individual export markets will require companies to be flexible in their range of products and markets and in the substitutability of both.

There will be no let up in the wage pressure caused by the shortage of qualified labour in Estonia. Improvements in efficiency in production will be unavoidable for companies if they are to remain competitive in international product and labour markets. Labour costs continued their rapid rise in early 2014 despite economic growth turning negative, though the rise will slow in the second half of the year. The need for wage rises to adjust is indicated by the steady increase in the share of companies that are losing competitiveness, the fall in corporate profitability, and the slow growth in prices in foreign markets, which puts ever more of a limit on the ability to pass wage costs into prices.

Companies with low productivity will find it harder and harder to cope with the competition for employees caused by the shortage of labour. Companies, the government and job-seekers all need to seek solutions for the bottlenecks in the labour market. The general government will need to contribute more than ever to reducing structural unemployment, as the qualifications of the unemployed often do not match the needs of companies, meaning there are both labour shortages and high unemployment simultaneously. To address this problem, the government will need to continue with its active labour market policies, with support from regional, education and population policies. A shrinking and ageing population also makes it necessary to deploy measures that will increase the labour force participation rate. Policy measures have an impact over a longer term, so unemployment is projected to fall slowly, meaning companies will need to help employees

improve their skills in order to cope with the shortage of labour.

The uncertain outlook for demand means that corporate investment activity has not increased yet. The utilisation of current capacity has increased to almost the same level as before the boom and the need for new production capital has consequently increased. The conditions favour an acceleration in investment growth, as loan interest rates remain low and bank loans easily accessible, while the ability of companies to finance investments using their own available resources has increased.

Households have been able to increase their consumption sharply as incomes have risen quickly and prices only slowly. The jump in electricity prices that followed the opening of the electricity market had an impact on consumer choices in 2013, but the impact faded in the first half of 2014 as the warm winter meant that electricity consumption was lower, while a new undersea cable between Estonia and Finland was energised, making electricity prices lower than they had been a year before. In the coming years the consumption and investment decisions of households will be affected by slower growth in incomes and faster growth in prices, which will combine to restrain the rise in real purchasing power.

The very slow inflation in consumer prices in the first half of 2014 will start to pick up steadily. Inflation will be pushed up by the improvement in the economies of partner countries, which will raise the prices of imports to Estonia, while price rises for domestic services will still remain moderate. Part of the rise in consumer prices in the coming years will come from the rise in excise taxes aimed at reducing alcohol and tobacco consumption and increasing the state budget revenues. Inflation in Estonia will be higher than the euro area average throughout the forecast horizon, but this can be explained by faster growth in the economy and in incomes.

The general government budget deficit will increase this year and next by more than was earlier forecast due to weakness in the economy and it will start to diminish in 2016 under the positive influence of the economic cycle. The targets for state financing have been relaxed under the new budget strategy, with the goal of achieving a nominal surplus postponed and the targeted structural surplus lowered. Although the general government finances will generally remain strong under the forecast, the budget targets need to allow enough leeway that any unforeseen need for consolidation should not lead to unexpected additional changes in tax policy. The basis for the agreed strategy must be that the tax environment should be stable and reliable for both companies and households.

The risks surrounding the outlook for the Estonian economy are mostly linked to possible developments in the external environment, but it is impossible to map out every possible negative scenario, as the further course of the conflict that started early this year between Russia and Ukraine, and the possible channels for impacts from it, cannot be predicted. The capacity for growth in exports may again be threatened by higher labour costs, which could start to hinder the competitiveness of companies in foreign markets if they cannot be offset by higher productivity. The forecast expects the strong growth in real estate prices to end this year, but it is not inconceivable that excessively optimistic expectations of households will make the pressure on real estate prices continue for some time yet, and that this will then culminate in a fall in prices as it did in the last real estate cycle.

This forecast contains four boxes of background information. The first reviews the latest developments in the monetary policy of the euro area, the second reviews investment in the Estonian economy in international comparison, the third

looks at the structure of Estonian goods exports by country of origin and explains the consequent different impacts on Estonian exports of economic developments in destination countries, and the fourth describes the drivers of inflation in the first half of 2014 and the possible risk of deflation.

THE EXTERNAL ENVIRONMENT

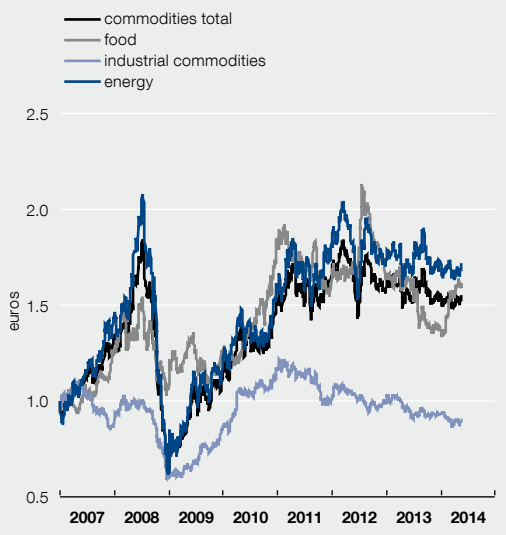
The general trend in global economic activity is one of growth, despite a temporary setback, and the trend is expected to continue in 2014 and 2015. Advanced economies will make a major contribution to this and will be the main drivers of global economic growth in the near term. Growth in emerging markets has slowed at the same time and the rotation of growth from emerging market economies to advanced economies will continue. Faster growth in advanced economies will have a positive impact on developing economies in the coming years, but structural problems and imbalances will prevent many developing economies from achieving rapid growth. Economic activity could be affected by geopolitical tensions. The possible worsening of the conflict between Russia and Ukraine has increased uncertainty about the speed of recovery in the region and in the global economy.

The tightening of American monetary policy has made the economic situation more complicated for emerging markets. Slower economic growth in China has weakened the confidence of countries that export goods and raw materials, and private consumption is not able to replace exports in developing economies. The accommodative monetary policies in advanced economies in recent years have given support to markedly increased inflows of foreign capital, and this has significantly boosted public and private debt in developing countries, making countries more vulnerable to volatility in markets and capital flows. As inflows of external capital have now slowed, investments can no longer be maintained at the same level. Future growth in emerging markets will depend on exports to advanced economies.

Demand in Estonia's trading partners has grown noticeably more slowly in 2014 than was forecast in December, and is now forecast to stand at 2.3%. Expectations for growth in the economies of trading partners have also worsened for 2015. Smaller growth in external demand is partly a consequence of modest economic growth in Finland and Russia, which are among Estonia's main trading partners. Finnish demand for imports is being held down by low domestic demand, and Estonia's exports to Russia are restricted by a depreciation of the rouble.

Price pressures for commodities remain relatively low, and only food commodities have gone up in price because of bad weather in early 2014 (see Figure 1). Although the assumed oil price will be slightly higher during the forecast horizon than was earlier estimated, there will be no major pressure on the oil price and the price will fall.

Figure 1. Commodity price indices* (January 2007=1)



* last observation 16/05/2014
Source: HWWI

Table 1. External assumptions in the forecast

					December 2013 projection		
	2013	2014	2015	2016	2013	2014	2015
Foreign demand growth (%)*	1.3	2.3	4.2	4.9	-0.3	3.9	5.2
Oil price (USD/barrel)	108.8	107.2	102.2	98.2	108.2	103.9	99.2
Interest rate (3-month EURIBOR, %)	0.22	0.26	0.25	0.43	0.22	0.27	0.48
USD/EUR exchange rate	1.33	1.38	1.38	1.38	1.33	1.34	1.34

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

This forecast expects the oil price to fall to an average of 98.2 USD per barrel in 2016. The fall in price will be driven by weakening demand caused by the slowing of growth in emerging markets. Food commodities will rise slightly in price this year and the gradual rise will continue throughout the forecast horizon.

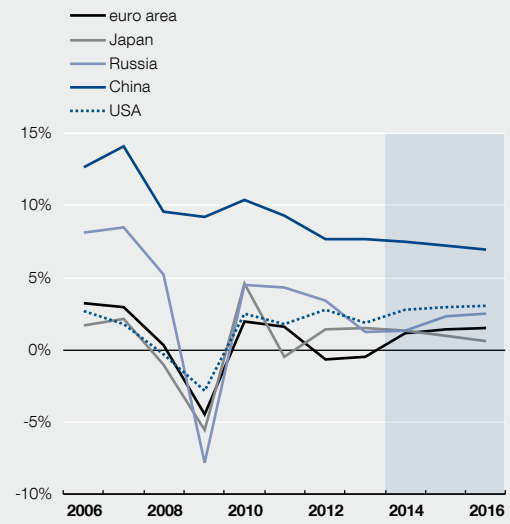
The euro exchange rate has strengthened in recent months. It has mainly risen because international investors are retiring from emerging markets and directing capital flows towards the euro area. The strength of the euro is also due to corrections in the exchange rates of major commodities-exporting countries and the weakness of the Japanese yen. The 3-month EURIBOR, the European short-term interbank interest rate, rises moderately throughout the forecast horizon (see Table 1).

Major economies

The American economy grew strongly at the end of 2013. The growth was driven by private consumption, exports and non-residential fixed investment. At the start of this year economic activity was held back in America by an extraordinarily cold winter, and this was reflected by a decline in corporate spending and a negative contribution from inventory building. The economy was held up by stronger consumption expenditure by households. In the short term, a recovery in economic growth is expected, and this will counteract the deceleration at the start of the year. Growth in employment points towards a recovery in the economy, as does a fall in the unemployment rate. The International Monetary Fund forecasts growth of between 2.8% and 3.0% in America in 2014 and 2015, (see Figure 2). Inflation will remain low in the United States and the Federal Reserve will continue determinedly with its exit from quantitative easing.

China's economic growth is slowing. Growth at the start of 2014 was more modest than expected and the lower economic sentiment has placed doubt over whether the annual growth

Figure 2. Output growth of larger economies



Source: IMF WEO, April 2014

target of 7.5% set by Government of China can be achieved. Inflation accelerated at the end of 2013 to close to the Government inflation target of 3.5%, though price pressures have remained modest at the start of 2014. The Chinese central bank has been quoting a steadily cheaper rate for the yuan against the dollar since February. One reason for the depreciation of the yuan is that China wants to support export growth because of its weak economic figures.

Growth in the economy in the United Kingdom accelerated in 2013. Stable economic growth will continue on the back of private consumption and investment in 2014 and 2015. Inflation has fallen steadily since the end of 2013 and low inflation allows the Bank of England to maintain its accommodative monetary policy for some time yet, with interest rates forecast to rise only at the start of 2015. However, the OECD warned the British government and the Bank of England of possible overheating in the housing market and added that the central bank should consider new micro and macro supervisory measures.

Growth in Japan remains stable with support from the labour market and private consumption, and corporate confidence has continued to strengthen. Growth in exports has been aided by a recovery in world trade and a weakening of the yen. At the same time, the economy will come under pressure in the near term from the need for fiscal consolidation and structural reforms.

Economic activity in the euro area has improved since the second half of 2013. Consumer confidence is clearly on the rise and surveys of sentiment in the euro area indicate that the economic improvement is continuing, as earlier forecast. However, growth continues to be restrained by high unemployment, high levels of government debt, delays to competitiveness reforms, and the possible negative effect on expectations of very low inflation. Inflation is restrained mainly because of a fall in commodity prices and the large negative output gap in the euro area economy. Due to a fall in inflation expectations, the European Central Bank eased monetary policy even further at the beginning of June (for more on the euro area monetary policy environment, see Box 1). The situation is further complicated by the high exchange rate of the euro against major currencies, which is also holding back economic growth and inflation.

Latvia and Lithuania

The Latvian economy grew strongly in 2013 and although growth will slow slightly in 2014 and 2015, it will still be the fastest in the European Union. Growth was principally supported by domestic demand, which is increasing mainly due to the increased consumption allowed by growth in household incomes. Household consumption got a further boost at the start of 2014 from a rise in the minimum wage and a cut in labour taxes, though rapid wage growth could hinder competitiveness. The labour market continues to improve as unemployment declines. Inflation in 2014 will be lower than was expected, mainly because the opening of the electricity market has been postponed to 2015.

Latvian investments and exports will grow relatively modestly in 2014. Economic activity will be strongly influenced by events in external markets. The downside risks for the economy are mainly associated with Russia, as an increase in tensions in the region could reduce trade in goods and damage the investment climate. A depreciation of the rouble will also put pressure on companies whose main target market is Russia. At the same time, investment growth should be supported by Latvia's entry into the euro area, as this will increase confidence in the Latvian economy.

Lithuania's economic growth in the first half of 2013 was mainly based on exports, but exports growth slowed in the second half of the

year, and economic growth was supported by domestic demand. Growth will continue to be driven by private consumption in 2014 and 2015, supported by strong wage growth, low inflation and improved confidence. Low interest rates will encourage private investment and public sector investment will also continue its strong growth. Both investments and the Lithuanian economy in general will be given additional confidence by the country's probable accession to the euro area in 2015.

The prospects for Lithuanian exports have deteriorated. On top of the uncertainty about foreign demand, export growth will be limited by the poor state of oil refining and fertiliser production in the country. Strong growth in private consumption and investment may however significantly accelerate the growth of imports, and this will turn the current account negative again from 2014.

Finland and Sweden

The Finnish economy was in decline for the second consecutive year in 2013 and the outlook is continually uncertain. It is expected that growth will return to the economy only very slowly in 2014 and 2015. Economic activity will mainly be restricted by weak domestic demand and low confidence, which will impose limitations on consumption and investment. A worsening labour market will hinder private consumption and wage growth will also remain modest in the short term. The recovery in the economy will also be restricted by the continuing fiscal consolidation by the government, which will lead to higher taxes and limits on government spending. Despite the tax rises, weak domestic demand means that inflation will remain low.

An improvement in Finnish economic activity will depend largely on the external environment. The external environment is expected to recover in 2014, mostly in the second half of the year. Weak domestic demand will keep growth in imports low, meaning that net exports will be positive in 2014. Although capacity utilisation in the Finnish manufacturing sector is low and the electronics industry has not recovered after the financial crisis, manufacturing should still gain some strength in 2014, mainly on the back of chemicals and the forestry industry.

The Swedish economy grew in the last quarter of 2013 by more than forecast and remained strong in the beginning of 2014, and solid growth is also expected in 2014 and 2015. The positive developments were confirmed by a steady improvement throughout 2013 in confidence, which exceeded its historical average in the first half of 2014. Growth is mainly supported by investment and domestic consumption. Household consumption is underpinned by low interest rates and improvements in the labour market, while growth in government consumption is accelerating due to higher social expenditures. Investment is mainly led by the construction sector, but increased activity in external markets will also bring higher investment growth in manufacturing. A recovery in external demand will be followed by growth in exports.

The challenge for the Swedish central bank's monetary policy is to find a balance between low inflation pressures and rising household debt burdens. Inflation in Sweden has been near deflation in recent months, but the central bank's objective is to keep inflation around 2%. The Swedish monetary policy repo rate has been 0.75% since December 2013, and the central bank has said that it will remain there for about a year.

Russia

Economic growth in Russia, which had recovered somewhat in the second half of 2013, has slowed this year and forecasts for growth have been lowered significantly. Economic growth was already based mainly on the export of raw

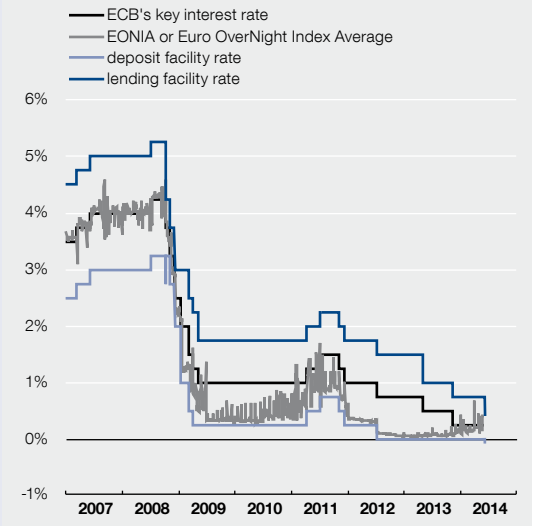
materials last year, and a deterioration in confidence and a slowdown in investment indicated a lack of economic activity. Pessimistic forecasts for 2014 show that growth could turn negative. The private consumption that has mainly driven growth before now is being restricted by higher interest rates for loans and a slowing of income real growth. The downside risks are mainly associated with a possible escalating of the conflict with Ukraine and the impact of sanctions resulting from that.

Increased uncertainty and vagueness about the development of the Russian economy and about any solution to the Ukrainian conflict have led to a sharp rise in the already large outflows of capital and have harmed investor confidence. To stop the continuing depreciation of the rouble and the outflows of capital, the Russian central bank was forced to intervene heavily in the foreign exchange markets. Even though growth is weak, the central bank raised the benchmark interest rate by 150 basis points in March to 7% and then to 7.5% in April, explaining it with increased inflationary pressures and the need to maintain financial stability. The Russian stock exchange and the rouble stabilised, but the outlook remains uncertain. At the same time, the weakness of the rouble may bring some support to the slowing economic growth and the federal budget.

Box 1: The monetary policy environment in the euro area

The monetary policy environment of the euro area remained favourable in the first half of 2014. The Governing Council of the European Central Bank lowered monetary policy interest rates in June to their lowest levels under the economic and monetary union, with the interest rate on the main refinancing operations at 0.15%, the interest rate on the deposit facility at -0.10%, and the interest rate on the lending facility at 0.40% (see Figure B1.1). The negative rate for the deposit facility, which has only ever been used before by a few central banks[1], applies only to the money held by credit institutions at the European Central Bank[2].

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



* last observation 06.06.2014
Source: European Central Bank/Bloomberg

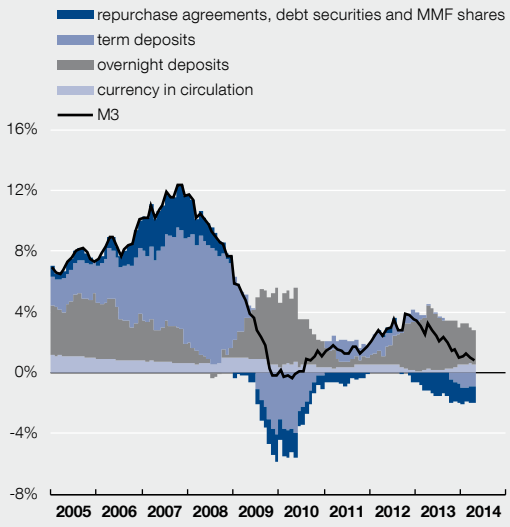
The Harmonised Index of Consumer Prices (HICP) for the euro area grew ever more slowly throughout 2014, with the growth rate remaining below 1% and reaching 0.5% in May, and turning negative in April in four Member States according to cross-country

1 Negative deposit interest rates were applied by the Swedish central bank in 2010 (see Minutes of the Executive Board's monetary policy meeting on 1 July 2009) and by the Danish central bank from July 2012 to April 2014 (see Monetary Review 3rd Quarter 2012 Part 1), principally to prevent the appreciation of the local currency.

2 See http://www.ecb.europa.eu/press/pr/date/2014/html/pr140605_3.en.html.

data. Inflation was mainly lower because of lower energy and food prices and in recent months it has been affected by the appreciation of the euro and by economic slack. Risks that have emerged include prices for energy and food, partly under the influence of geopolitical tensions; any further rise in the euro exchange rate; and any failure in the additional consolidation measures of Member States. The assessment of the Governing Council of the European Central Bank is that inflationary risks in the euro area will be in balance and in line with the price stability aim of keeping inflation rates below but close to 2% over the medium term. The June macroeconomic projections by Eurosystem staff find that inflation will remain low in the euro area for some time yet, but will rise to 1.4% in 2016, reaching 1.5% in the fourth quarter[3]. A survey by the European Central Bank in the second quarter showed that professional forecasters expect long-term inflation for the euro area to be 1.8% in 2018[4]. Instruments that reflect inflation expectations have fallen slightly only for short-term inflation expectations, while long-term expectations remain anchored.

Figure B1.2. Euro area annual money growth*



* last observation April 2014
Source: European Central Bank

The annual growth rate of the broad monetary aggregate M3 slowed from 1.4% in October 2013 to 0.8% in April (see Figure B1.2). Liquid instruments like deposits and cash were the principal contributors to the growth in the money supply. Deposits from households grew less quickly this year in annual terms and grew by only 1.5% in April, while deposits placed by non-financial corporations grew faster, reaching a growth rate of 6.5% at the end of 2013, though this fell back to 5.8% in April. This may have been a result of investment being delayed as companies maintain buffers in order to raise funds in debt and equity markets. The interest rates for non-financial sector deposits remain low at below 2%. The experience of Denmark and Sweden with negative deposit rates does not give grounds to suppose that the commercial banks of the euro area will lower deposit interest rates for the non-financial sector to any large degree. Investors are looking for instruments with a higher return during a time when the recovery in confidence is slow and the credit supply to the non-financial sector is modest, which is why the growth in M3 is based on an increase in the net external assets of monetary financial institutions. Annual growth in lending to the non-financial sector in the euro area remained low throughout 2014 and fell to -1.8% in April. Although credit growth to households remains close to zero, the growth in lending for house purchases is positive and was 0.7% in April. The corporate loan stock shrank

3 ECB press conference, 5 June 2014.

4 See http://www.ecb.europa.eu/stats/prices/indic/forecast/html/index.en.html.

by 2.8% in April, down from 3.7% in October 2013. However, the latest Bank Lending Survey of the euro area shows that the speed of the tightening of lending conditions to the non-financial sector has been reduced gradually[5] and demand for credit has started to grow. The apparently positive impact of cuts in the monetary policy interest rates for the euro area together with the use of non-standard monetary policy measures and the announcement of Outright Monetary Transactions, or OMTs, has gradually been passed into the loan interest rates of the non-financial sector, and the loan rates on mortgages and on corporate loans, especially those for between 250,000 and 1 million euros, are 60-70 basis point lower than in 2012.

On top of its traditional monetary policy measures, the Eurosystem has continued with its non-standard measures to support the functioning of transmission channels. At the start of June the Governing Council of the European Central Bank announced a comprehensive package of measures[6]. From September 2014 to September 2018, banks in the euro area will be offered targeted long-term loans that credit institutions can use to lend onwards to non-financial corporations. Priority was also given to intensifying preparatory work related to outright purchases in the asset backed securities, or ABS, market because of the role played by this segment of the market in revitalising new credit flows to the economy, especially the non-financial sector. It was also decided to extend the main refinancing operations as fixed rate tender procedures with full allotment at least until the end of 2016. Euro area credit institutions have also continued to repay their loans under the three-year longer-term refinancing operations[7] ahead of repayment deadlines. The operations have shrunk substantially in size, which shows that the liquidity position of the euro area banks is improving little by little, though more slowly in the south of Europe than in the rest of the euro area. At the end of 2013 these loans were also paid back to the Eurosystem to a larger extent than they were earlier because of the upcoming asset quality review for credit institutions in the euro area. At the end of May banks had paid back more than 574 billion euros, or 54% of the total loans.

The Governing Council of the European Central Bank continued to use forward guidance in the first half of 2014 in communicating its monetary policy decisions and the outlook for price stability. This has kept money markets, which are the first stage in the transmission of monetary policy, stable even when inflation has been low. To keep market expectations anchored, the Governing Council of the European Central Bank added the explanation that despite some improvement in the outlook for the economy, euro area monetary policy interest rates would remain low for an extended period of time because production capacity is underutilised to a very large extent. The President of the European Central Bank, Mario Draghi, confirmed that the Governing Council is unanimous in its commitment to using additional non-standard monetary

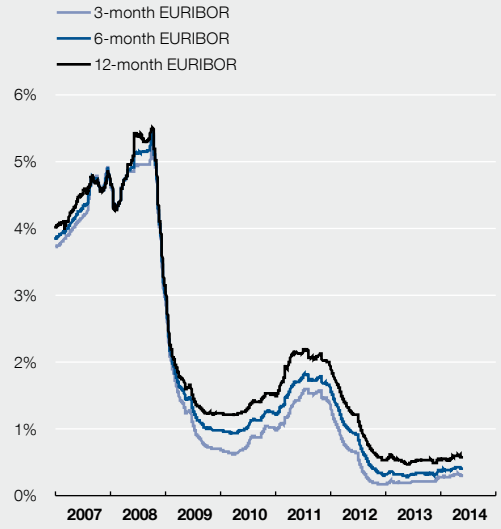
5 See http://www.ecb.europa.eu/stats/money/surveys/lend/html/index.en.html. Stricter lending conditions are interpreted in the survey by analysing the net difference in the shares of those banks that have noted in the review that they have tightened credit conditions such as interest margins or collateral 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.

6 See http://www.ecb.europa.eu/press/pr/date/2014/html/pr140605_2.en.html and http://www.ecb.europa.eu/press/pr/date/2014/html/pr140605_1.en.html.

7 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.

policy instruments within its mandate to cope effectively with the risks of inflation remaining low over too prolonged a period[8].

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



* last observation 28.05.2014
Source: Bloomberg

The central bank influences short-term interest rates[9] in the money markets through its own monetary policy interest rates, and long-term interest rates depend on the expectations for short-term interest rates. EONIA[10] varied between 0.10% and 0.69% between December 2013 and May 2014, but was mostly below the base interest rate of 0.25% set by the European Central Bank, which applied until the beginning of June. For technical reasons EONIA is often higher on the last days of the month, but in January and April it was temporarily more volatile than usual. This was because of a sharp reduction in excess liquidity[11] in the Eurosystem to below 100 billion euros, which last happened in August 2011, partly because of a jump in repayments of loans under long-term refinancing operations, and partly because government deposits increased and banks had greater need of liquidity at Easter. Excess liquidity increased again after the operations by the European Central Bank to increase liquidity, and EONIA fell below the base interest rate of the European Central Bank. Although banks have traded more actively in overnight markets, indicating an easing in the liquidity situation, the fragmentation of liquidity markets in the euro area is also a cause of volatility in EONIA. The fluctuations in short-term interest rates have not affected long-term interest rates, and the small rise in those rates is principally a sign of a normalisation. In May the short-term money market interest rates were less than 10 basis points up on the levels of the end of November, with the three-month EURIBOR[12] at 0.30%, the six-month EURIBOR at 0.40%, and the twelve-month EURIBOR at 0.58% (see Figure B1.3). The money market yield curve as shown by the gap in the one-month and twelve-month EURIBOR was the same in May as in November 2013 at close to 30 basis points.

8 ECB press conference, 5 June 2014.

9 Interest rates fixed for up to one year.

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

11 Liquidity beyond the need for liquidity in the banking system of the euro area. Excess liquidity comes from autonomous factors and reserve requirements: permanent facilities (the deposit facility - overnight loans) + excess reserves (the current account balance - minimum reserve requirement).

12 The Euro Interbank Offered Rate for lending between banks across Europe.

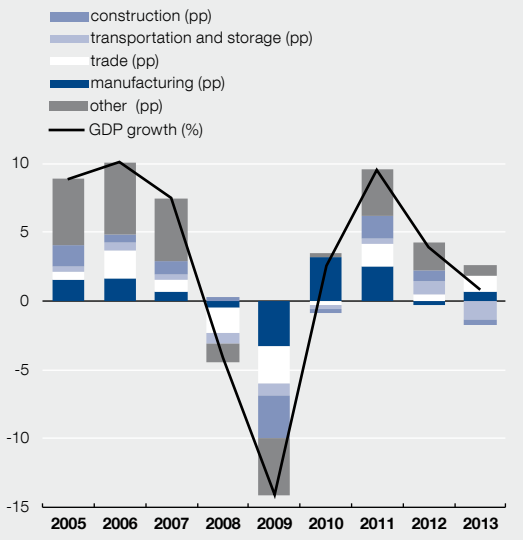
ECONOMIC ACTIVITY

The Estonian economy grew by 0.8% in 2013 at constant prices. The growth was largely based on domestic demand, which was mainly driven by increased private consumption. Higher wage incomes last year boosted private consumption, which grew by 4.2%. Growth in investment was slowed by a reduction in general government investment, and fixed capital formation increased by only 1.1% over the year.

The slowdown in GDP growth was quite narrowly based across sectors in 2013 (see Figure 3). The value-added of transportation and storage fell by more than 19% during the year, reducing total economic growth by 1.4 percentage points. There was a decline in construction as a consequence of the reduction in investment from the general government, and this took 0.4 percentage point off economic growth. The retail sector was boosted by rapid growth in private consumption and added 1.1 percentage points to growth. The value added from manufacturing, which is mainly directed towards exports, increased by more than 5% over the year and lifted GDP growth by 0.7 percentage point.

Estonia's economic growth in 2013 remained below its long-term potential. This shows that Estonian companies could produce more than current demand will take, and means that the GDP gap is negative and the economy is running at below its potential. This is confirmed by the industry survey of the Estonian Institute of Economic Research, which shows that the main factor restricting output growth in recent years has been weak demand. However, rapid rises in unit labour costs indicate that the labour market gap is positive and unemployment has fallen to a level where it is creating wage pressures. The contradiction between the labour market gap and the GDP gap shows that employers expecting the economy to recover have hired more labour than is needed to fulfil current orders.

Figure 3. Contributions to output growth by sector



Source: Statistics Estonia

The high level of employment has pulled unemployment below its equilibrium level. At the same time, equipment is underused and the average number of hours worked per employee could equally be increased further. The biggest contribution to the GDP gap comes from the cyclically low level of productivity, which indicates that the labour employed in anticipation of higher demand would be able to produce more than can currently be sold (see Figure 4). If demand recovers, it can be the main factor in the growth of the economy.

Their current numbers of employees mean that companies will be able to increase production quickly when demand recovers. Although annual output growth will accelerate significantly only from 2015, the forecast expects quarterly growth to pick up before then. The slow growth in 2014 is mainly a consequence of the poor growth at the end of 2013 and the negative growth in the first quarter of 2014. That decline was largely based in the energy sector, which contributed little to total output, mainly because of warm weather.

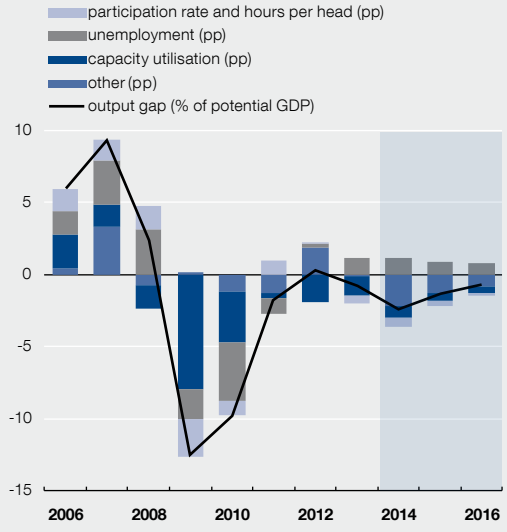
The impact of this will fade in the second quarter, and this will boost growth in quarterly terms.

Economic growth is forecast to accelerate to 3.9% in 2015 and to 3.6% in 2016. GDP growth will accelerate in 2015 as unused production capacity is brought into use. The economy will be approaching its full potential in 2016 and growth will depend more on supply-side factors like capital, labour and technological development in addition to demand factors.

Productivity measured as GDP per worker will grow somewhat faster than GDP throughout the forecast horizon as employment shrinks. Emigration and the low birth rate in the 1990s will together shrink the working age population, and this will have a negative impact on growth throughout the period covered by the forecast. The impact of the decline in the working age population on GDP will be softened by greater labour force participation and lower unemployment. The decline in the working age population will mean that the search for staff will have ever more of an impact on the success of companies. Employee development and additional training have become important in the same way.

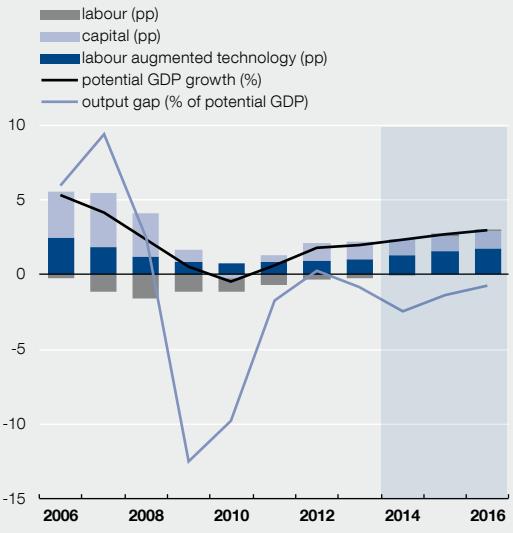
Estonia's potential GDP growth rate is slower than that in the years before the crisis in 2008, because the pace of technological catch-up has slowed as the technology gap to the richest European countries has been reduced (see Figure 5). Potential GDP growth will also be restricted by the decline in the working age population, though this will be partly offset by a rise in the participation rate and a fall in structural unemployment. The slow growth in potential GDP after the crisis of 2008 is a result of changes in the structure of the economy. The value added from transportation and storage has fallen in recent years and is not expected to return to its earlier levels immediately. If such factors have less of an influence on potential GDP growth, technological factors will drive its

Figure 4. Decomposition of the ouput gap



Source: Statistics Estonia, Eesti Pank, European Commission

Figure 5. Potential growth and the output gap



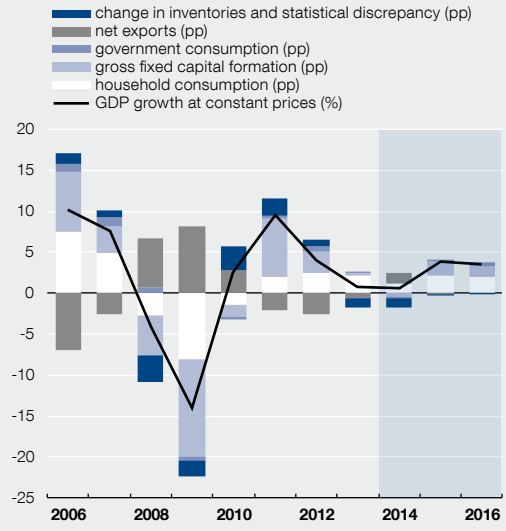
Source: Statistics Estonia, Eesti Pank

acceleration. Alongside technological advances is the deepening of capital through an increase in capital per worker, which will also make a positive contribution to potential GDP growth.

Growth in exports will be needed if Estonian living standards are to be harmonised with those of the European Union. For this to happen, a recovery is needed in export markets and companies must remain competitive. The economy grew in 2013 largely on the back of private consumption, which in turn was based on higher wage incomes. It is important for growth that the higher production costs caused by wage growth should not start to limit the capacity of companies to export. Data from the European Commission show that at the beginning of the second quarter of 2014 the number of companies where competitiveness had increased was larger than the number of companies where it had decreased. However, the share of companies that have managed to increase their competitiveness has shrunk steadily as unit labour costs have risen. It is forecast that export growth will pick up as external demand improves, though increasing demand for investment means net exports will remain close to zero throughout the forecast horizon (see Figure 6).

The recovery in external demand will increase the contribution of manufacturing to economic growth. The outlook for manufacturing may be restricted by rapid rises in production costs. This will affect subsectors with low value added most, as they will not be able to compete for labour if labour shortages become more severe. The increase in production using modern technology will accelerate the harmonisation of incomes with those of the richer countries in Europe. Wage growth will inevitably lead to manufacturing with low productivity relocating to countries with cheaper labour and to some job losses. If labour costs rise too fast, even the more productive sectors may be unable to cope, and this would raise unemployment and slow economic development.

Figure 6. GDP growth by expenditure method



Source: Statistics Estonia, Eesti Pank

The transit flows running through Estonia will not return to their earlier levels during the years of the forecast, and the transport sector will not recover from its decline in 2013 during the forecast period. Transportation and storage will continue to have a negative impact on economic growth in 2014, though the speed of decline will fall during the year. The problems of the transport sector have mainly come about because the goods that have up to now been transported through Estonia are going through other countries. Estonian rail transport volumes first fell in 2007 and still remain at a low level.

Growth in the construction industry was limited in 2013 by a lack of orders from the public sector and this will continue to limit it throughout the forecast horizon, though it will be partially offset by increased investment from the private sector. General government investments are forecast to remain smaller than in 2012 throughout the forecast period, and they will give little support to the construction sector. The production of materials for road-building shrank in the first months

Table 2. Economic forecast by key indicators*

					Difference from previous forecast		
	2013	2014	2015	2016	2013	2014	2015
Nominal GDP (EUR billion)	18.43	19.19	20.45	21.79	0.04	-0.27	-0.54
GDP, volume change (%)	0.8	0.7	3.9	3.6	-0.2	-1.9	0.0
CPI, change (%)	2.8	0.8	2.4	2.7	-0.1	-1.3	-0.5
HICP, change (%)	3.2	1.3	2.8	3.0	-0.1	-1.0	-0.2
GDP deflator, change (%)	5.0	3.4	2.6	2.9	0.4	0.3	-1.2
Current account (% of GDP)	-1.0	-0.7	-1.8	-1.7	0.9	1.2	-0.3
Private consumption expenditures, volume change (%)	4.2	2.3	4.0	3.8	-0.6	-1.1	0.1
Government consumption expenditures, volume change (%)	1.3	-0.3	0.9	2.2	1.3	-2.0	-0.3
Gross fixed capital formation, volume change (%)	1.1	-2.0	7.6	5.2	3.9	-5.6	1.5
Exports, volume change (%)	1.8	2.2	3.5	4.5	-0.2	-0.9	-3.5
Imports, volume change (%)	2.6	0.8	3.8	4.6	-0.4	-2.2	-3.1
Unemployment rate (%)	8.6	8.5	8.5	8.3	-0.1	0.0	0.2
Domestic employment, change (%)	1.9	-1.3	-0.3	-0.4	-0.4	-0.9	0.0
Productivity per employed person, change (%)	-1.0	2.0	4.2	4.0	0.3	-1.0	0.0
Real compensation per employee, change (%)	3.2	5.4	3.2	4.0	2.4	1.7	-1.5
Average gross wage, change (%)	7.8	6.0	6.2	6.7	0.0	-0.6	-1.5
Private sector debt, outstanding amount change (%)	1.3	1.8	3.0	4.1	-0.3	-2.3	-2.8
Gross external debt (% of GDP)	87.4	82.2	79.1	76.2	-4.2	-6.7	-5.1
Budget balance (% of GDP)	-0.2	-0.6	-0.8	-0.3	0.0	-0.3	-0.7

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

of 2014, but the production of building materials increased, which reflects the growth in orders from the private sector.

This forecast does not take account of the possible impact of the conflict that started in early 2014 in Ukraine. Industry survey data available at the time of writing indicate principally that expectations worsened at the time of the conflict. However, assessments of orders did not decline in March or in April. The deterioration in economic relations between Russia and Europe in connection with the conflict in Ukraine could have a major impact on the forecast.

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

DOMESTIC DEMAND

Domestic demand grew by 1.5% in 2013 with support from strong growth in private consumption. The ability and willingness of consumers to consume improved while the general government had less money from external sources for investment than it did before and companies lacked the confidence to start major investment projects because of uncertainty about the outlook for demand. Growth in domestic demand also slowed because the poor economic circumstances meant that inventories grew only slowly. Private consumption will also support domestic demand in 2014, but domestic demand will fall slightly because of the inventory cycle and low investment activity. When the economy grows

with support from increasing external demand in 2015 and 2016, domestic demand growth will speed up together with investment growth.

Private consumption

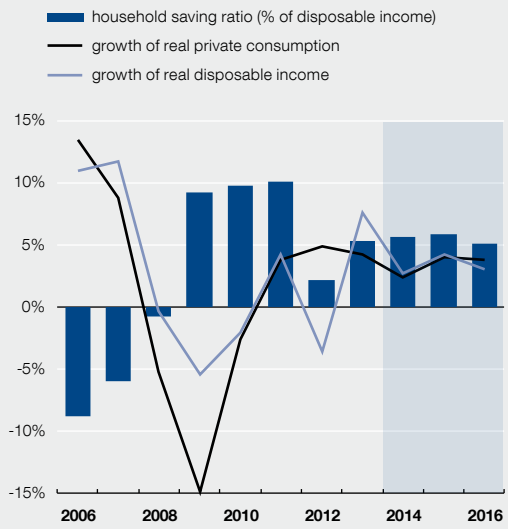
Private consumption grew fast in 2013 because of positive developments in the labour market, which saw the average wage rise rapidly, the number of employed increase and the number of unemployed fall. These labour market developments were also reflected in consumer confidence. The consumer survey of the Estonian Institute of Economic Research showed that fear of losing a job fell significantly last year, and the economic outlook for households was more positive than before. Consumer confidence remained above its historical average throughout 2013 and improved sharply in the fourth quarter of the year.

The real purchasing power of households in Estonia increased in 2013 as incomes rose and inflation fell. The increased purchasing power and higher confidence supported growth of 4.2% in private consumption at constant prices in 2013. The main contribution to consumption growth came from food products and from goods and services for recreation and culture. Although consumers' fear of losing their jobs declined, not all of the increase in wages was used for consumption, as households also increased their savings. Preliminary data indicate that households saved a little over 5% of their disposable income in 2013[13].

Although growth in household consumption will slow in 2014, it remains a major source of economic growth. The impact of the continued rapid rise in average monthly wages and low inflation kept retail growth high in the first quarter, but the warm winter reduced the amount households spent on heating. Wage growth will slow during the year and employment will fall, with the result that household incomes will grow markedly more slowly than they did in 2013. Consumer purchasing power will continue to grow though, as inflation will remain moderate this year. The forecast expects that private consumption will grow by 2.3% in 2014 and the household savings rate will remain the same as last year.

Private consumption will continue to make a major contribution to economic growth in 2015 and 2016, when consumption growth will rise to close to 4%. The reduction in the income tax rate and the rise in the income tax-free threshold will boost the increase in both household incomes and consumption at the start of 2015. Household consumption is forecast to grow in the coming years at a similar speed to real disposable income, and the savings rate will remain close to 5% (see Figure 7).

Figure 7. Private consumption



Source: Statistics Estonia, Eesti Pank

13 Household disposable income is found by adding pensions, benefits, income earned abroad, dividends and other household income to compensation to employees. Compensation to employees supplies about 90% of disposable income.

Gross fixed capital formation

Gross fixed capital formation at constant prices increased by 1.1% in 2013. The investment to GDP ratio was 25.3%, which was the highest figure in the European Union (for more about investment in the Estonian economy, see Box 2).

Investment grew slowly in 2013 mainly because investment from the general government fell. Gross fixed capital formation by the general government rose through the use of external sources of funds to an all-time record level in 2012. There was a decline in 2013 in the scale of projects funded by revenue from the sale of emission quotas, and transfers from the European Union were smaller than in the previous year, leading to a fall in general government investment at constant prices of 21.3%.

Government investment will change little during the forecast horizon as transfers from the European Union will not contribute to investment growth in the coming years. It is forecast that government investment will decrease slightly in 2014, and will not change a great deal in 2015 and 2016 as applications for support under the new budget period of the European Union take time. The main impact of the freeze in government investment levels will be felt in construction.

Gross fixed capital formation at constant prices increased in 2013 because of corporate investment. Investments by non-financial companies increased by 8.6%, which offset the reduction in government investment. Both corporate investment in construction and capital formation in machinery and equipment grew strongly. Certain sectors led the growth in corporate investment, with capital formation in the energy sector increasing again, while one-off investments in the transport sector also made a significant contribution. Less was invested in manufacturing than in 2012, even though production capacity utilisation rose. Investment by manufacturing companies was restrained by a deterioration in confidence caused by a lack of orders.

Although corporate investments will fall for 2014 as a whole, companies' interest in financing the streamlining and expansion of business increased. The decline in investment in 2014 as a whole is due to the result of the first quarter, but investment activity will certainly increase in subsequent quarters. The rapid rise in labour costs has increased the need for production to be made more efficient. A survey of investments in manufacturing by the Estonian Institute of Economic Research found that the main aim of investments in 2014 was rationalisation. Investment is planned more and more in expanding production, since production capacity utilisation in manufacturing is approaching its average of before the boom. The outlook for demand growth is still uncertain, which can hinder decision-making about investments and so hinder investment growth.

An improvement in the economies of Estonia's main export partners and increased opportunities for exporting will lead corporate investment to rise quite quickly in 2015 and 2016. The recovery in corporate investment will revitalise the construction sector since the increase in private investments in construction will help compensate for the lack of orders from the public sector. As the funding position of companies is good, a faster recovery in demand than forecast may lead to substantial growth in investment.

Gross capital formation in residential space increased at constant prices by 5.6% in 2013. Rapidly rising incomes and favourable borrowing terms allowed households to improve their living conditions. At the same time building costs rose very fast at the beginning of 2013 because of the rise in labour costs, and the incentive for building companies to build residential space decreased. The combined effect of higher building costs and higher demand was that the price index for residential space rose by more than 10% in 2013.

Growth in investment in residential space will speed up slightly in 2014. Data from the Estonian Land Board show that the amount private people paid for new residential space in the first quarter was more than a year earlier. Large rises in sales prices and stable prices for construction have increased the profitability of real estate projects recently, meaning that residential construction has become more attractive. The supply of new residential space will increase in 2014, which should ease the price pressures caused by supply shortages. Demand from households for new residential space will be maintained at higher levels than previously by rapidly growing incomes and low interest rates. As wage growth slows in the coming years, so investment in residential space will probably also be somewhat slower. The risk to the forecast is of excessively optimistic expectations for rising real estate prices, as these could increase the desire of investors to invest in real estate, leading property investments to grow faster than forecast.

Figure 8. Gross fixed capital formation

Source: Statistics Estonia, Eesti Pank

Gross fixed capital formation will decline slightly in 2014, but will increase again in 2015 and 2016 with support from corporate investments (see Figure 8). There will be little change in the investment to GDP ratio, which has been higher than in other European countries.

Changes in inventories

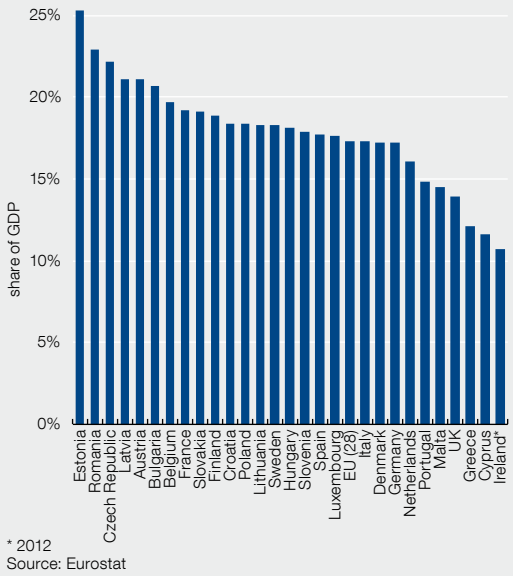
As economic growth slowed, so growth in inventories was slower in 2013 than in preceding years, with the result that change in inventories had a large negative impact on domestic demand growth. Inventories of both raw materials and unfinished products shrank in the construction sector because of low demand. Inventories also shrank in the real estate sector but in contrast to the construction industry, this was because market activity was higher. Rapid growth in private consumption led to increases in inventories of goods purchased for sale in the trade sector.

Inventories are forecast to increase even more slowly in 2014 due to low levels of economic activity and it will have an additional negative impact on domestic demand growth. As private consumption will grow by less than before, the retail sector will equally not increase its stocks by as much as it did earlier. It is forecast that inventories will continue to grow slowly in 2015 and 2016 and that their contribution to domestic demand growth will remain small.

Box 2: Investment in the Estonian economy

Investment as a share of GDP in Estonia has been very high against that seen in other European countries over the past twenty years. Although gross fixed capital formation in Estonia in 2013 was practically the same as in the previous year, increasing by only 1.1% at constant prices, the ratio of investment to GDP still remained the highest in the European Union (see Figure B2.1).

Figure B2.1. Gross fixed capital formation in 2013



* 2012
Source: Eurostat

The high ratio of investment to GDP can be attributed to the convergence of income levels with those of richer countries. The neoclassical theory of economic growth explains differences in income levels between countries through differences in the quality of factors of production and the volume of such factors per capita. The ratio of labour and capital is generally low in poorer countries, and they lag behind richer countries in their use of technology. There is a consensus in the economic literature that for the long-term growth needed for incomes to catch up with those of richer countries to be achieved, capital deepening[14] and the use of modern technology are important, and this is reflected in relatively higher investment intensity. The United Nations Economic Commission for Europe has found a strong positive relationship between investment intensity and long-term economic growth[15].

The relative income level per capita at purchasing power parity, PPP, in Estonia was one of the lowest in Europe in 1996. After that[16] the ratio of investments to GDP in Estonia has been higher than that of the richest countries in the European Union (see Figure B2.2), and this has been accompanied by rapid economic growth. A clear positive link between the ratio of investment to GDP and economic growth can be defined for the countries of the European Union, as countries where investment activity has been higher have grown faster, which is in line with the theory of income convergence (see Figure B2.3).

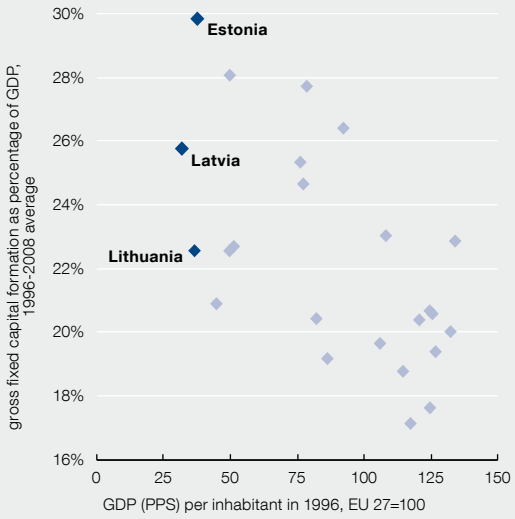
At PPP, relative income per capita in Estonia has risen sharply against the average European income level and stood at 71.2% of the European average in 2012. It follows from the theory

14 Capital deepening means an increase in the capital intensiveness of production and is measured as the ratio of capital to GDP.

15 Catching Up and Falling Behind: Economic Convergence in Europe. Economic Survey of Europe, 2000 No 1.

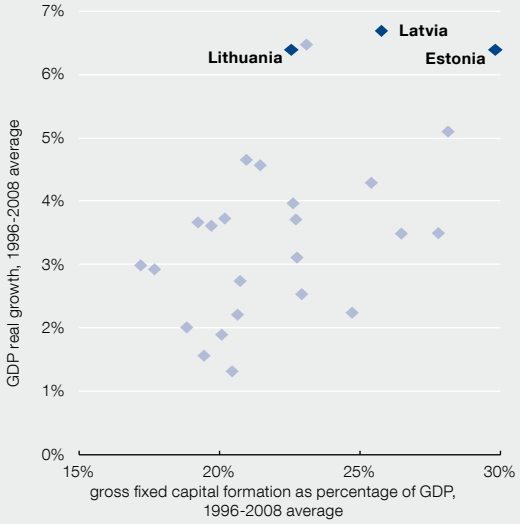
16 The period observed is 1996–2008, the years of the crisis are not included.

Figure B2.2. Level of income and gross fixed capital formation in the European Union



Source: Eurostat

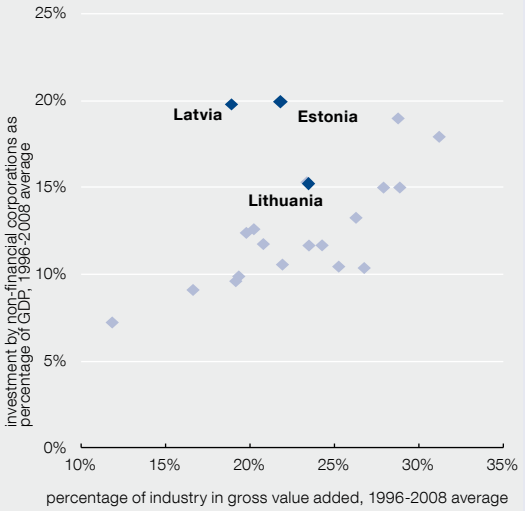
Figure B2.3. Gross fixed capital formation and GDP real growth in the European Union



Note: Greece and Malta omitted due to lack of data
Source: Eurostat

that a rise in the relative income level should be accompanied by a fall in the ratio of investment to GDP. This is partly because the period of rapid capital deepening has ended, and partly because of changes in the structure of the economy. The share of services in the economy has generally increased in richer countries and services are less capital intensive, while the share of the manufacturing sector has declined. In consequence, countries where the share of value added created by manufacturing is smaller have a lower ratio of corporate investment to GDP (see Figure B2.4). The share of value added created by manufacturing companies in Estonia has remained close to its long-term average and it is forecast that there will be no changes in investment intensity resulting from changes in the structure of the economy in the coming years.

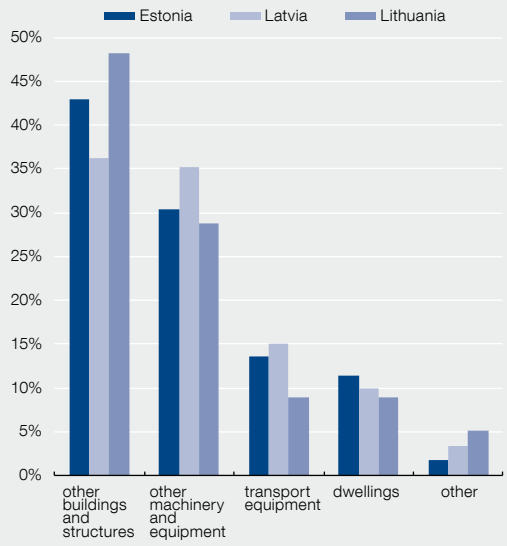
Figure B2.4. Investment by non-financial corporations and the share of industry in gross value added



Note: Bulgaria, Croatia, Greece, Ireland, Luxembourg, Malta and Spain omitted due to lack of data
Source: Eurostat

It is noticeable that while Latvia and Lithuania invested relatively less than Estonia in 1996-2008, the average economic growth there was faster than that in Estonia over the period (see Figure B2.3). Differences in the structure of investments do not explain how the same speed of economic growth was achieved with different levels of investment activity, as Latvia has invested relatively more in machinery and equipment and in transport than Estonia has, but Lithuanian investments in those types of capital were smaller than those in Estonia (see Figure B2.5). Utilisation of capital is equally unable to explain the difference in growth rates, as Estonia used its production resources more intensively in 1996-2008 than the other two countries did.

Figure B2.5. Investment structure, 1996-2008 average



Source: Eurostat

EXTERNAL BALANCE AND COMPETITIVENESS

The Estonian current account remained moderately in deficit in 2013 at 1% of GDP, though it was some 40% smaller than the deficit of the year before. Lower external demand mainly affected exports of goods, though the restrained investment activity also reduced imports of capital goods. Exports and imports of services continued to grow however, and the balance of the goods and services account was positive at current prices. The goods and services account at current prices actually increased in GDP calculations, but not in the data for the balance of payments. Goods and services data are different for the balance of payments and for GDP calculations, as the balance of payments data also include payments for goods under merchanting, at least until the full adoption of the BPM6[17] standards in 2014. The main cause of the reduction in the current account deficit was a decrease in the deficit in the income account as the income earned by Estonian residents abroad grew and the income earned by non-residents in Estonia declined, primarily because of the change in the investment position. Growth in investment in Estonia decreased, partly because Estonian residents bought businesses back from foreign direct investors.

The positive development of net exports at current prices was affected strongly in 2013 by favourable terms of trade. Export prices for goods and services rose by 1.0% over the year but import prices fell by 0.4%. In real terms net exports had a negative impact on economic growth in 2013, but this impact was much smaller than it was last year.

17 The IMF's Balance of Payments and International Investment Position Manual, 6th Edition.

Assumptions about demand growth in Estonia's main trading partners have been adjusted downwards for 2014 and 2015, even though the economy of the euro area is returning ever more surely to growth. The assumptions have mainly been adjusted downwards because import demand in some of Estonia's biggest trading partners, notably Russia and Finland, has been weaker than was earlier forecast. Growth in exports of Estonian goods and services to CIS countries may have been affected significantly in the first half of 2014 by exchange rates and weakness in import demand due to political tensions.

The flash estimate of GDP shows that goods exports at constant prices fell by 1.8% over the year in the first quarter of 2014 while goods imports increased by 1.2% and the goods account deficit widened. However, the monthly flash estimate of the balance of payments indicates that this has been balanced by the favourable developments for services, and the goods and services balance as a ratio to GDP remained positive overall. The estimate shows the services balance for the first quarter of 2014 was better than at the same time a year before. Services exports grew by 5.9% over the year, and imports by only 2.1%.

The decline in goods exports was strongly affected by a fall in exports of machinery and equipment, mainly to Sweden, and a fall in exports of chemical products, with exports to Russia contributing one third of the fall. The size of goods flows was again affected by a reduction in the transport of mineral fuels from Russia through Estonia to other countries, which have practically no impact on net exports and are largely taken out of the statistics for Estonian exports under the rules of the system of national accounts[18]. Imports of goods to Estonia fell in the first quarter, and reductions were seen in both goods intended for export and imported investment goods.

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. Estonian goods exports have grown by more than twice as much as external demand in recent years, but during the forecast horizon they will grow more slowly than external demand. Factors related to the conflict between Russia and Ukraine affected Estonian exports in the first half of 2014. The depreciation of the Russian rouble reduced the purchasing power of Russia and several other CIS countries, but in general prices in euros fell in the target markets for Estonian exports. Estonian export prices to target markets did not follow that fall, though prices stopped rising. The total of Estonian exports did change though, and export volumes fell as prices were not lowered. More detailed analysis shows that the reduction in growth in Finnish and Russian demand has not been fully transmitted into the figures for Estonian exports. If Estonian exports are decomposed by country of origin, it was only the export of goods that originated in other countries that shrank in 2013, and the related storage and transport services (see Box 3). The forecast expects that Estonian exports of goods and services will grow in the coming years at a similar rate to external demand, and even faster at current prices. The forecast for imports of goods is dependent on developments in domestic demand and exports. A small rise in the ratio of imports to 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 contribution of net exports to economic growth is forecast to turn positive in 2014 as external demand regains strength and investment activity declines. In the longer term, the return of investments based on large-scale

18 These are transit flows including the cost of goods under merchanting.

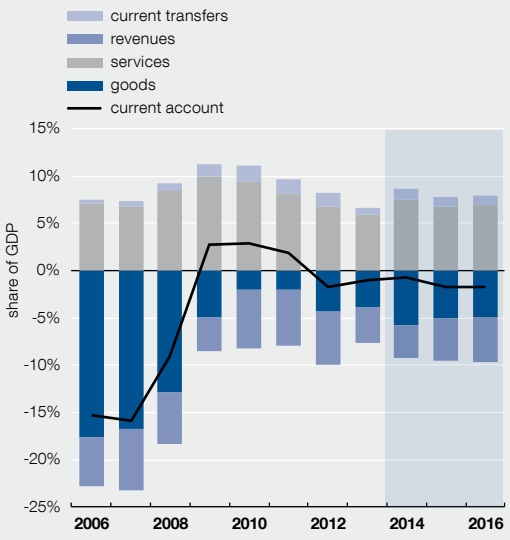
imports will mean that the contribution of net exports to GDP growth will be close to zero or slightly negative. Faster growth in exports of services and slower growth in imports of investment goods mean that the balance of the goods and services account will be more positive in 2014 than was earlier forecast, and the current account deficit will be smaller (see Figure 9).

Terms of trade have been favourable for Estonia for some time as prices for exports rise somewhat faster than prices of imports. The euro has appreciated against the currencies of several major trading partners in 2014, which has affected the prices of Estonian exports. This has meant that terms of trade are no longer so favourable for Estonia, and the forecast expects that exports of goods and services at constant prices will grow slightly faster than imports only at the end of the forecast horizon. Rises in the prices of imports will be held down during the forecast horizon by relatively slow growth in prices of commodities. The forecast for prices of exports is based on the forecast for the prices of imports in the main target markets, and also considers rapid rises in domestic prices. The strong growth in wages in Estonia will eventually be passed through into the prices of exported goods and services, and if this means prices rise faster than those of competitors, it could restrain Estonian exports.

Faster growth in the price of Estonian exports than in the prices in export markets is partly a reflection of a shift in the structure of exports towards products with higher value added and of a positive change in position in the outsourcing value chain. Prices of Estonian exports have grown significantly faster than those in foreign markets, and this trend will continue in the coming years.

The forecast expects that income outflows will increase in the coming years, mainly due to investment income. Because foreigners have

Figure 9. Current account



Source: Statistics Estonia, Eesti Pank

larger investments in Estonia than Estonians have abroad, the recovery in profits will push the income account deeper into negative territory. The surplus on the current transfers account will not change much in the period covered by the forecast. The current account deficit will shrink to 0.7% of GDP in 2014, and will increase slightly in subsequent years as investment recovers, though it will still remain below 2% of GDP.

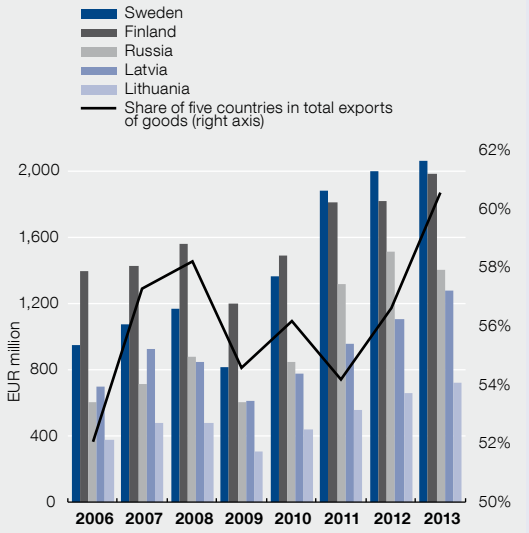
As the current account deficit is slightly smaller than was earlier forecast, the ratio of external debt to GDP will shrink slightly faster during the forecast horizon. The gross external debt, which is the external debt of all the economic sectors in the country as a ratio to GDP, fell by the end of 2013 from a year earlier by eight percentage points to 87% of GDP, mainly because credit institutions and other private sector companies reduced their indebtedness. The net external debt, which is debt assets less debt liabilities, was positive for the second consecutive year at the end of 2013 by around 6.6% of GDP. Estonia's gross external debt will increase

slightly in the next few years, but more slowly than nominal GDP growth. The forecast expects that creditless economic growth will continue, as the economy grows out of its debt thanks to rapid GDP growth, and by the end of the forecast horizon, external debt as a share of GDP will be smaller than it was in the boom years, and it will be around 76% of GDP by the end of 2016.

Box 3: The structure of Estonia's goods exports by country of origin

Estonian goods exports are very diverse in both their products and their markets. The uneven recovery in the global economy in 2013 and at the start of 2014 led external demand for Estonian products to grow more slowly, particularly demand from Finland and Russia, which are important target markets among Estonia's near neighbours. This box looks at the structure of Estonian goods exports by country of origin for the five main target markets. The structure of trade is very different for different target markets and for that reason the effect of economic growth and of market demand in those countries on Estonian goods exports and value added can vary too.

Figure B3.1. Estonian exports of goods at current prices and the share of the five main partner countries in total exports of goods



Source: Statistics Estonia

Changes in demand in external markets can affect both the prices and volumes of exports. The change in export volumes at constant prices directly affects real GDP growth and can itself be affected by changes in price-based competitiveness. Value-based market shares that are measured at current prices also reflect changes in terms of trade, and best describe earnings of export income as they cover changes in both volumes and prices. The difference in market shares measured by volume and by value shows the relative development of prices. How strong the impact of relative prices is depends on the very different price elasticities for demand in export markets for different products and countries. It is significant that Estonia is not only a price-taker in export target markets despite its small size, which might have been expected if Estonia only exported end-products and only to markets with full competition. However, the prices of Estonian exports of goods and services rose almost twice as fast in 2004-2013 as import prices in target markets[19]. This suggests the relationship between export capacity and relative prices has changed over time.

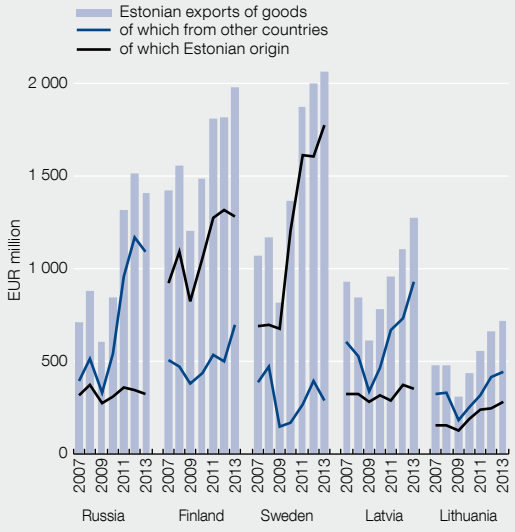
19 For more details see the Estonian Competitiveness Report. Eesti Pank. 2014

The most important target markets for Estonian exports in recent years have been Sweden, Finland, Russia, Latvia and Lithuania. Foreign trade statistics show that the share of Estonian exports taken by these five countries together varied between 52% and 61% in 2006-2013 (see Figure B3.1). The country that took the largest individual share of Estonian exports in 2013 was Sweden, which received 16.8% of the total, while Finland came second with 16.1% followed by Russia with 11.4%, Latvia with 10.4% and Lithuania with 5.8%.

The goods exports statistics cover the total cost of the goods, which can contain many production inputs, including the imported machinery, raw materials and semi-finished products needed for producing export goods. The import content of exports is very different for different export goods, meaning that the contributions of their exports to economic growth can vary too[20]. Increased exports of some products show that the volumes of goods flows through Estonia have increased and that local companies are only mediating the re-export of goods, buying storage, transport and other services here. Exports of some other products contain much more value added created domestically through mid-range and high technology[21]. The content of exported products differs markedly from target country to target country and so sharp changes in demand in different target markets can have different impacts on Estonian value added and on economic growth.

It is possible to distinguish between Estonian export goods of Estonian and foreign origin in the foreign trade statistics. Although the value of export goods produced in Estonia also contains imported inputs, they make up a much higher proportion of goods of foreign origin and can even reach 100%. In recent years the sale of goods from other countries through Estonia has increased, and this change has been biggest for goods heading in the direction of Russia. Dividing goods exports between those of Estonian origin and those transported through Estonia from other countries reveals that more than 77% of goods exported from Estonia to Russia in 2013 were produced in other countries. Similarly, 73% of exports to Latvia and 61% of exports to Lithuania were produced in other countries (see Figure B3.2).

Figure B3.2. Estonian exports of goods at current prices to main destination countries



Sources: Statistics Estonia, Eesti Pank

Goods from foreign countries arrive in Estonian warehouses or companies and after some

20 Estonian Economy and Monetary Policy (2/2013). Eesti Pank. 2013.

21 Riina Kerner. The exports of goods and services and the domestic value they contain. Statistics Estonia, 2013.

reprocessing and the addition of some service costs they are sold on. This increases exports of Estonian services as Estonian companies provide services like logistics and transport services in that case. The contribution of exported goods produced in Estonia to growth in value added is significantly larger however, as not only the transport industry but also local producers are involved. Goods of Estonian origin are in the majority among Estonian exports to Finland and Sweden and accounted for 65% of goods going to Finland and 86% of those going to Sweden in 2013. This means that growth in Scandinavian markets, or an unexpected contraction there, can have a major impact on Estonian exports and the value added created in the economy. The Finnish and Swedish markets affect Estonian exports differently as a large part of the domestically produced exports going to Sweden are electronic goods, where demand comes from the world market and the effect of Swedish economic growth is weak, while exports to Finland are less concentrated and depend more on developments in the target market, meaning that events in the Finnish market can have wide-ranging impacts on Estonian exports and GDP growth.

Machinery and equipment provided 56% of Estonian exports to Sweden and such exports continued to increase, doing so by 9% in 2013. Exports of mineral products and of metal products to Sweden were smaller and fell last year by 59% and 4% respectively because of both lower prices and reduced volumes. Exports of goods to Finland were 0.4% larger than a year ago[22] and only a few of the main components of exports saw growth, primarily wood products with 7.8% and chemical products with 8.6%. Exports of other products like food, metal, machinery and equipment, and other goods declined, largely following the general decline in demand for imports in Finland. The biggest contributors to growth in exports from Estonia to Latvia were mineral goods, chemicals, textiles and wood products, and live animals and animal products. Exports of mineral products to Lithuania fell, while exports of vehicles, chemical and metal products, and live animals and animal products all increased. Among those groups of goods, only live animals and animal products had a majority of content that originated in Estonia. Exports of machinery and equipment and chemical and metal products from Estonia to Russia fell over the year, and the share of the content of these goods which is of foreign origin is above average. Among groups of goods where the share of goods of Estonian origin is larger, export growth was quite fast, with exports of food products increasing by 8.4% and exports of wood products by 13%, which was faster than general import demand growth in Russia. The conclusion from this is that Estonian goods and services exports developed very differently in different target markets and different groups of goods. The reduction in growth in Finnish and Russian demand has not been fully transmitted into the figures for exports. The main decline in goods exports came in goods originating in other countries and the storage and transport services costs associated with them. This had a noticeable effect on economic growth in 2013, as the fall in the value added of transportation and storage contributed a great deal to the drop in GDP growth.

22 This excludes a one-off transaction for ships. The foreign trade statistics recorded the cross-border movement of two ferries, one exported and one imported, in the first quarter of 2013. The two transactions were between non-residents and did not affect the external assets or liabilities of residents.

THE LABOUR MARKET

The slow economic growth in 2013 and the decline in early 2014 led to more signs of imbalance appearing in the labour market. In the last quarter of 2013 and the first of 2014, the first signs of cooling appeared in the labour market as wage growth slowed and employment growth stopped but unit labour costs continued rising despite this. The pressure from labour costs pushed corporate profitability down and increased the likelihood that the expected adjustment will be larger than had been forecast.

Employment

The slower growth in GDP in 2013 and the fall in the first quarter of 2014 were reflected in the labour market as the number of employed stopped rising in the second half of 2013 and fell in the first quarter of 2014. The revised labour market statistics, which take into account both the natural decline of the working age population and migration, show that total employment grew by 1% in 2013, adding 0.2% in the second half. Employment was 0.7% lower in the first quarter of 2014 than a year earlier, while the working age population shrank by 0.9% over the same period. Alternative data sources for employment, such as the wage survey, the Tax and Customs Board and financial statistics of enterprises, indicate a continued slowing of growth in employment.

Employment is forecast to fall in 2014 by 1.1%, and growth will remain negative throughout the forecast horizon (see Figure 10). The decline in employment represents the adjustment of the economy to the rapid rise in labour costs, which has not been matched by a rise in productivity. This means that less efficient companies are making a loss and have to scale down operations, which reduces the demand for labour. In this way, labour costs will adjust during the forecast horizon partly through a reduction in employment, but the employment rate will not change much as the working age population is shrinking.

Figure 10. Labour force and employment growth

Sources: Statistics Estonia, Eesti Pank

The outlook for employment growth in the exporting sector in 2014 is not encouraging, because the recovery in external demand is still yet to arrive and wages have risen sharply despite this. Although export growth is forecast to return from the second half of 2014, this will not necessarily be accompanied by a similar rate of growth in employment. Manufacturing companies can probably increase production by making more efficient use of their labour resources, which is needed to restore profits as a share of value added. Profit margins fell in 2012-2013 as labour costs increased substantially. The industrial confidence indicator shows a sharp fall in expectations for employment from March 2014 to May.

Demand for labour in construction was affected by a reduction in government investment in 2013 and the contribution of construction to employment growth will remain negative throughout the

forecast horizon. General government investment will be smaller in both 2014 and 2015 than it was in the recent past. Despite favourable interest rates and rapid rises in property prices, the demand for labour in construction for the private sector has not been enough to offset the impact of the reduction in government investment completely. The sharp rise in unit labour costs in construction suggests a fall in profitability and pressure to recover it. The economic sentiment indicator also showed that expectations for employment in construction have been pessimistic for some time already.

Growth in employment has been fastest in the service sector, where weak external demand and lower investment have less impact than they do in manufacturing. The labour force survey shows that employment in services grew by 2.6% in 2013 and by 2.3% in the first quarter of 2014. Consumption of services grew as incomes rose faster and household confidence increased. Economic sentiment indicators show that service sector companies have had more optimistic expectations for employment than companies in other sectors, though the proportion of companies who consider labour shortages to be a factor restricting output increased in the second quarter.

It is forecast that general government employment will fall slightly in 2014, but not change significantly after that. Given the wage rises in the second half of 2013, it will be hard to remain within the payroll limits planned in the state budget in 2014 if there is not a reduction in the number of employed. The labour force survey shows that employment in the public sector fell by 0.6% in 2013 while data from the Tax and Customs Board show that the number receiving wages from the register of government institutions has fallen steadily since 2012 and continued to do so at the start of 2014.

This forecast takes account of emigration and the natural decrease in the working age population for the first time. The basis for the population forecast is the more pessimistic scenario of the population forecast by Statistics Estonia, in which the age-based tendency to migrate maintains its long-term trend at the start of the forecast period and net migration is negative. The working age population will shrink by an average of 0.8% in each year covered by the forecast because of emigration and natural changes and the effect will be to increase tensions in the labour market as the labour supply shrinks.

Unemployment

The declines in the working age population and in labour force participation in the first quarter of 2014 affected unemployment more than the fall in the number of employed did. Unemployment fell in 2013 by 1.4 percentage points over the year, but the seasonally adjusted rate rose slightly in the second half of the year. Seasonally adjusted unemployment fell sharply in the first quarter of 2014 from the 8.8% of the previous quarter to 7.7%, mainly because the labour force participation rate fell. Data from Töötukassa, the unemployment insurance fund, show the fall in registered unemployment in the second half of 2013 and early 2014 getting faster and the probability of the registered unemployed moving into work increasing.

Wages rising faster than productivity indicates that there is a shortage of available labour and that unemployment is below the NAWRU rate[23]. Employers have raised wages despite the relatively high unemployment in order to keep hold of qualified employees and attract new ones. Although the long-term unemployment usually associated with structural unemployment has been falling as a share of total unemployment since 2012, it still stood at 44.5% in 2013. The big differences in the risk of unemployment between different levels of education, nationality

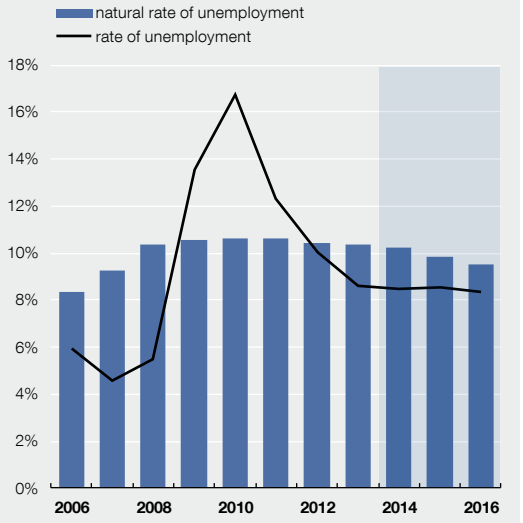
23 The non-accelerating wage rate of unemployment (NAWRU) is the level of unemployment where wage rises do not accelerate.

and place of residence all indicate that unemployment is structural.

This forecast expects the non-accelerating wage rate of unemployment to fall slowly over the forecast horizon (see Figure 11). The fall will reflect the reduction in structural unemployment in that those who became unemployed during the crisis will have found work in other sectors of the economy. The fall in structural unemployment is important as it will help to mitigate the shortage of labour and reduce wage pressures, which in turn will make it easier for employers to take on new employees.

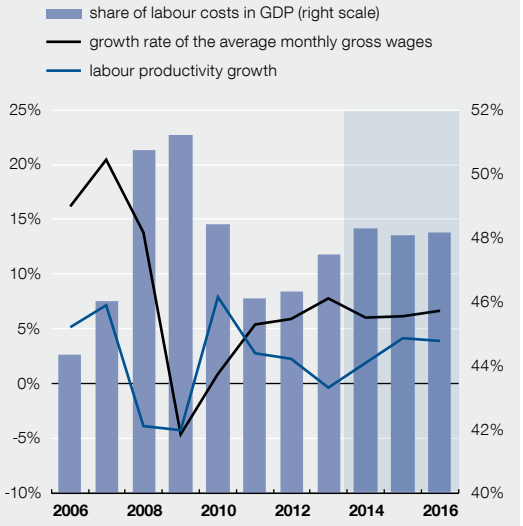
Registered unemployment fell in the beginning of the second quarter of 2014 and the number receiving taxed wage income rose. The main factor behind the forecast for unemployment is that the fall in the participation rate is forecast to be temporary in the first quarter and to return to its earlier level in the second quarter. The expectations of consumers for unemployment remain optimistic. The longer forecast is for both unemployment and the unemployment gap to fall slowly. By the end of the forecast horizon in the fourth quarter of 2016 unemployment will have fallen to 8.2%.

Figure 11. Unemployment



Sources: Statistics Estonia, Eesti Pank

Figure 12. Wages and productivity



Sources: Statistics Estonia, Eesti Pank

Wages and labour costs

Although economic growth was weak in 2013, average wages rose ever faster, with rises accelerating from 5.9% in 2012 to 7.8%. Part of the reason for the rapid rate of increase is that the fall in output growth had a relatively narrow base, was moderate in nominal terms, and affected sectors that are less labour-intensive.

Wage growth is forecast to remain moderate in the coming years, slowing to 6% in 2014 but picking up to 6.7% in 2016 (see Figure 12). Wage pressures will come from several sources during the forecast horizon, one of which will be the rises in the minimum wage of 10.9% in 2014 and 9.9% in 2015. The collective pay agreements that

came into force in both the public and private sectors last year will be passed partly into wage growth this year. The most important factors in long-term wage pressures are the shortage of labour caused by the shrinking labour force, and the stronger position of employees in wage negotiations, which is enhanced by the option of going to work abroad.

Wage growth will be restrained by the reduction in the profitability of companies, as they become unable to raise wages at the same speed as before. It will be harder for wage growth to continue in the government sector because of the need to limit spending and because the effect of the wage rises in the second half of 2013 will be passed into 2014.

As the payroll had increased significantly as a share of GDP by the start of 2014, wages will have to grow more slowly than productivity for some time in order for profitability to recover. Growth in unit labour costs accelerated in 2013 to 8.1%, with annual growth in the fourth quarter standing at 9.1% and probably picking up even further in 2014 as GDP fell. It is forecast that unit labour costs will grow more slowly in the second half of 2014 and in 2015 as productivity increases, but the payroll as a share of value added will still be notably larger than it was at its lowest point when the economy adjusted after the crisis. The shift in the position of employees is thus forecast to be a long-term one.

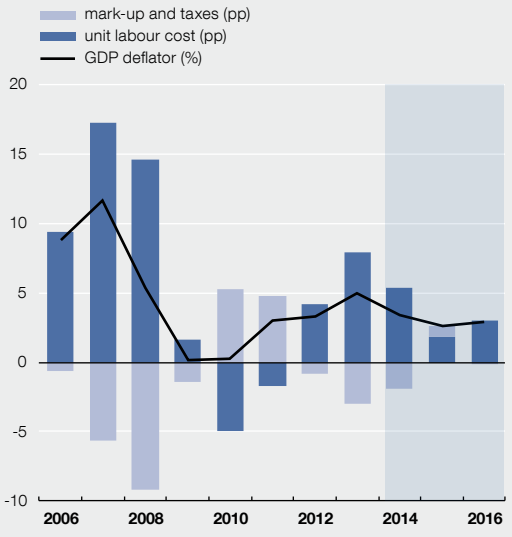
INFLATION

Inflation started to fall in the second half of 2013 and continued to do so in the first quarter of 2014 as consumer price inflation fell in March to 0.7%. The low rate of inflation was caused by both domestic and external factors.

Lower commodity prices and a strong euro brought import prices down, which partially counterbalanced the price pressures coming from the labour market. The external environment has a large impact as imported goods make up around 40% of the consumer basket. Inflation was greatly affected by cheaper imported energy, which allows consumers to consume more and supports the real growth of the economy. Energy takes a larger share of the Estonian consumer basket than it does of the euro area's, and this means that the fall in energy prices has had a larger impact on inflation here. The fall in prices of imports will still prove temporary and prices are projected to rise during the forecast horizon together with global economic growth.

Demand side price pressures have been moderate due to low economic activity and a fall in producer prices. As prices have risen more slowly than company costs have, corporate profit margins have fallen for three years in a row and real unit labour costs will rise for the same reason by 1.8% in 2014. Company costs have mainly increased because of the rapid rise in payroll costs. It is forecast that profit margins will start to grow in 2015 as wage growth slows (see Figure 13).

Figure 13. Composition of the GDP deflator growth

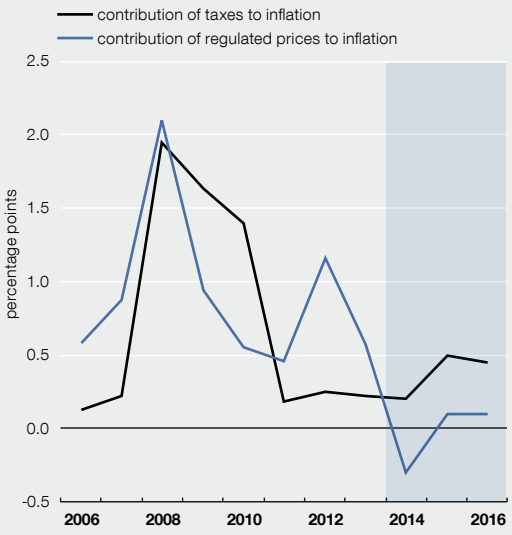


Sources: Statistics Estonia, Eesti Pank

The impact of tax rises and regulated prices on inflation will be small this year but will increase in the coming years (see Figure 14). Inflation has been higher than the euro area average in Estonia for several years mainly due to the impact of energy market opening, but in the coming years energy prices will converge at a slower pace. The effect of tax changes on inflation in 2015–2016 will increase as excise duty on alcohol and tobacco and on gas are raised and the contribution of tax measures to inflation is expected to reach 0.5 percentage point.

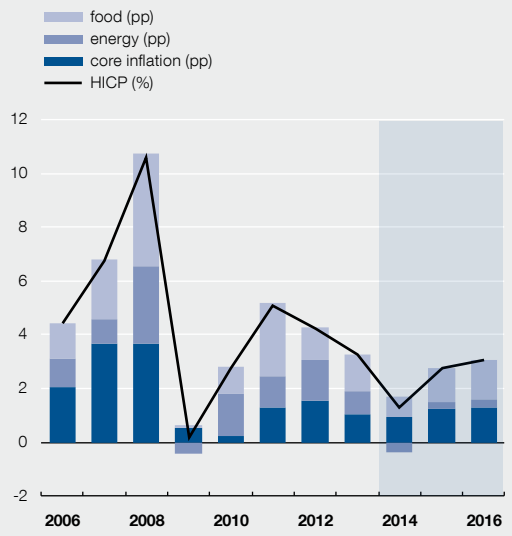
Inflation in Estonia will remain unusually low in the first half of 2014, but the risk of sustained deflation is relatively small (see Box 4). Although inflation will rise to 2.8% in 2015, it will still be contained by the economy passing its cyclical trough. In 2016 higher prices for imports will have an increasing impact on inflation alongside that from wage rises, lifting inflation to 3.0% (see Figure 15). Inflation in Estonia will be higher than the euro area average throughout the forecast horizon partly because of the continued price convergence, which will be reflected in services prices in particular. The price level of goods was 84.1% of the European Union average in 2012, but the market based price of services reached only 69% at the same time.

Figure 14. Tax changes and regulated prices



Sources: Statistics Estonia, Eesti Pank

Figure 15. HICP growth



Sources: Statistics Estonia, Eesti Pank

Food

Food inflation fell steadily in the second half of 2013 and continued to do so in the first quarter of 2014. The main reason was that prices fell for fruit and vegetables due to favourable harvesting conditions. Having risen quickly for several years, prices for meat and fish also fell. One factor contributing to the fall in prices may be difficulties in exporting to Russia. Food price growth will be moderate in the second half of 2014, and the acceleration in price rises is forecast to have been deferred until the last months of the year. Acceleration in food price inflation will be underpinned in the coming years by higher prices for European agricultural produce.

Food price inflation will also be affected significantly in 2015 and 2016 by the sharp rise in excise on alcohol and tobacco. The new government is planning to raise alcohol excise by 15% in 2015 and by 10% in subsequent years, while tobacco excise will be raised by 5% a year in 2016-2018. Higher excise rates are expected to add 0.4-0.5 percentage point to inflation.

Energy

The price of energy in the first quarter of 2014 was 3.9% lower than a year earlier. All components contributed to the fall in energy prices, though the main causes were electricity and heat. The main assumption of the inflation forecast is that the world market price level of crude oil will not change significantly.

Heat energy fell in price by 3.6% in the first quarter, which was a result of the euro exchange rate strengthening and the crude oil price falling to lower than what it was a year earlier. The cost of imported gas, and thus the price of heat, depends on changes in the oil price in the preceding three quarters, but the pass-through of recent declines into consumer prices is soon going to be exhausted.

The price of electricity has been volatile in recent years and hard to predict. When the electricity market opened for households in January 2013 the price rose 24%, with prices continuing to rise in the following months. As electricity generation capacity in the Baltic states was smaller than consumption and external connections were limited, price rises reached 38% in June. This changed in January 2014 when a new electricity cable was energised that increased the capacity to import from the Nordic countries. The result was that the electricity price fell by 4.2% in the first quarter from a year earlier. The electricity price is currently around 16% higher than in December 2012, before the electricity market opened. Electricity futures indicate that the price of electricity will remain fairly stable throughout the forecast horizon. Volatility in prices may be caused by the weather, unforeseen interruptions to production or increased consumption.

Core inflation

Core inflation covers manufactured goods and services. It does not include changes in the prices of energy and food, which are mainly dependent on external factors.

Inflation for manufactured goods was at its lowest for four years in the first quarter of 2014 at 0.8%. The disinflation in prices for manufactured goods was mainly a result of a fall in import prices but inflation has also slowed for clothing and footwear, where the share of domestic mark-up is high. Prices for clothing and footwear rose markedly faster than the euro area average in Estonia earlier, even though price levels were roughly comparable. Inflation for manufactured goods will rise somewhat in the coming years as import prices rise, but will remain moderate at close to 1%.

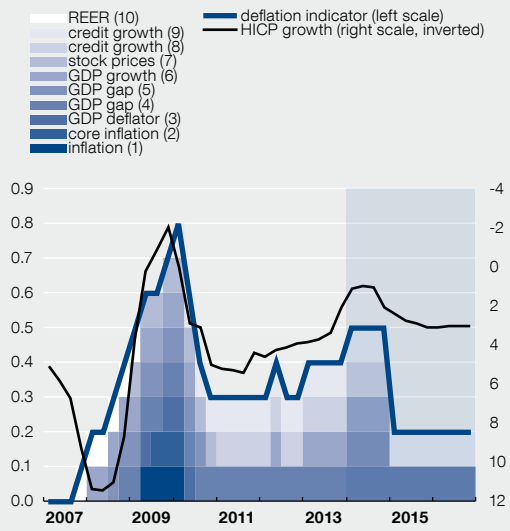
The pass-through of wage rises into prices for services has been slower than was earlier forecast. Services inflation has been held down in recent years by falling prices for communications. It has also been restrained by administrative measures, as public transport became free in Tallinn from last year, bringing inflation down by 0.2 percentage point, and a higher education reform made higher education free from the autumn, reducing inflation by 0.3 percentage point.

In the second half of 2014 services inflation will start to accelerate, partly because the free services will pass out of the reference base. Services inflation will return to its long-term trend in 2015 due to rapid wage growth, and will reach 3.5-4% in the coming years.

Box 4: Measuring the risk of deflation using the methodology of the IMF.

The fall in import prices and low economic activity meant that inflation in Estonia fell close to zero in 2014 despite rapid wage rises. The probability of the price level falling over the long term and deflation appearing is not very high, but the possibility that prices will rise only slowly for several years should not be discounted.

Figure B4.1. Deflation indicator



Source: Eurostat, European Commission, Eesti Pank

The IMF introduced a deflation indicator during the years of global crisis in 2008–2009, which aggregates ten equally weighted macroeconomic indicators of deflation risk[24]. The possible risk factors that are included are the following: 1) current inflation rate of <0.5%; 2) current core inflation rate of <0.5%; 3) growth in the GDP deflator of <0.5%; 4) an output gap of <-2%; 5) a change in the output gap over the last eight quarters of <2%; 6) real GDP growth over the past three years of less than 2/3 of the average of the last decade; 7) a decline in share prices over the last three years of >30%; 8) cumulative credit growth over the past three years of <10%; 9) an annual growth rate of credit smaller than that of nominal GDP; 10) an appreciation in the real effective exchange rate during the year of >4%. The possible range of values for the indicator ranges from zero to one, where a value below 0.2 means the risk of deflation is negligible and a value above 0.5 means it is large, with values in between meaning the risk is assessed as small or moderate.

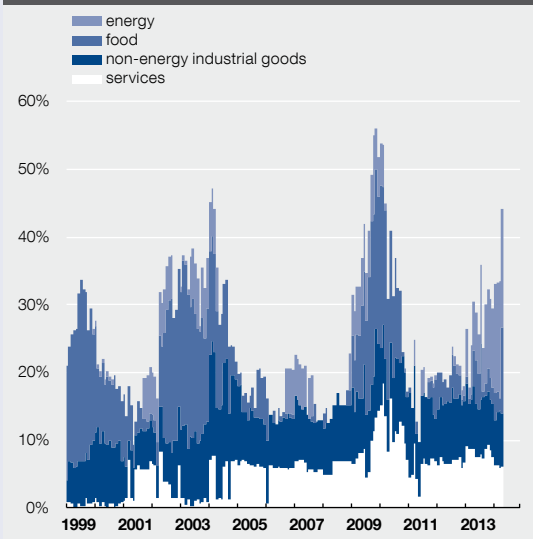
The deflation indicator calculated on Estonian data reached 0.5 in the first quarter of 2014, which suggests a moderate risk of deflation (see Figure B4.1). Although the value for the indicator has risen in recent years, the current risk of falling prices is significantly smaller than it was during the crisis years in 2008-09. The probability of deflation is mainly increased by weakness in economic activity and a negative GDP gap. Periods of deflation are visible not only in the macroeconomic indicators but also in the structure of price changes, such as an increase in the share of goods in the consumer basket that have falling prices (see Figure B4.2). In the past decade there were two periods that stood out because prices were rising significantly more slowly than the average. Inflation slowed notably in early 2003, mainly because prices of food products and manufactured goods fell in global markets. The only time when prices were falling started in May 2009 and the fall in this case was much more broadly based.

24 Deflation risks and the relationship between inflation and the business cycle in the euro area and some member states. Banka d'Italia, January 2014.

Inflation has slowed since autumn 2013 mainly because the volatile components of energy and food have become cheaper. Falls in prices have so far only been seen to a small extent in the components of core inflation, where services inflation is indeed accelerating. An exception is communications services, where higher productivity has allowed prices for the service to fall. The possibility of deflation is suggested however by the price dynamics for manufactured goods. There have been sharp falls in inflation for durable goods like cars and household electronics and also for clothing and footwear.

Despite the slow growth in prices, the survey data for household inflation expectations have not lowered significantly in recent months. The Eesti Pank forecast similarly indicates that the risk of deflation will fall rapidly and remain low in the coming years (see Figure B4.2). The risk of deflation will fall because the improvement in the external environment will let Estonian economic growth climb up from its current low level and credit growth will recover gradually during the forecast horizon, though it will continue to have only a modest impact on inflation.

Figure B4.2. Share of falling prices in consumer basket



Sources: Statistics Estonia, Eesti Pank

GENERAL GOVERNMENT FINANCING

The Riigikogu passed the State Budget Act at the start of this year, which confirmed the strengthening of the fiscal framework to meet the requirements of the European Union. The main amendment to the law is a requirement for the budget to be in structural balance, which means that the state budget must be drawn up so that the structural fiscal position of the general government would be in balance at least[25]. The new budget rules do not imply any substantial change for Estonian fiscal policy as there has been a tradition of keeping the budget in balance since the start of the 1990s. A structural fiscal deficit has also only occurred exceptionally.

Budget revenue

The structure of the economy in 2013 favoured tax receipts from labour taxes. Wage rises picked up and despite a reduction in the unemployment insurance payment rate, receipts from labour taxes grew faster than the economy. As incomes rose rapidly in 2013, so did private consumption, which boosted revenues from taxes on production, though VAT and excise receipts were lower than expected, partly in consequence of tax fraud and changes in consumer preferences. Receipts from corporate income tax were higher than usual last year as dividends were taken,

25 A Fiscal Council was set up to monitor the macroeconomic assumptions used in the state budget and how the budget is adhered to, so as to ensure that the economic forecast of the Ministry of Finance and the financial forecast that underpins it are suitably conservative.

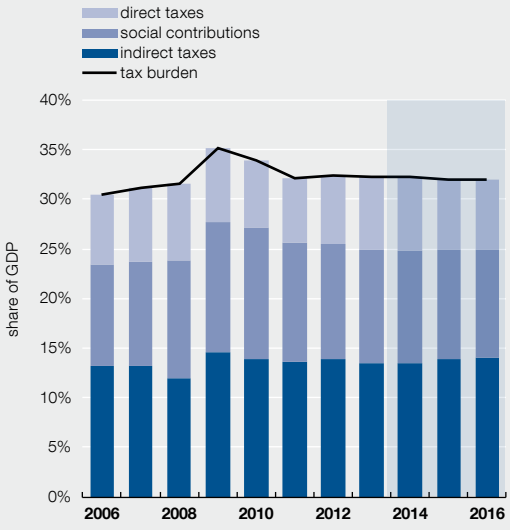
primarily in the private sector. Government tax revenues increased by 5.5% in 2013, while the tax burden fell slightly to 32.2% of GDP.

Tax receipts started to grow faster in early 2014 despite the decline in the economy. As economic growth was based on domestic demand and exports remained weak, one tenth more was received in VAT than a year earlier. Revenues from labour taxes increased because the rapid wage growth continued and income tax rebates were smaller than previously. It is forecast that labour costs will grow faster than the economy in 2014, meaning that labour taxes will increase as a share of the budget revenue, but they will fall again in 2015-2016 as wage rises slow and policy measures are implemented.

Planned changes to tax policy will have a significant effect on tax revenues throughout the forecast horizon. The new government reviewed its policy goals in 2014 and decided to accelerate the move from taxes on labour to taxes on consumption by raising taxes on unhealthy behaviour, cutting the use of fiscally marked oil, and reducing VAT exemptions and tax fraud, counterbalancing this by reducing unemployment insurance payments and raising the income tax-free threshold. In addition, it was previously agreed that income tax rates for both companies and households would be lowered in 2015.

Many of the changes to the budget will apply from 2015 and their combined effect on the general government budget balance will remain modest. 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. It is forecast that the tax burden will remain at around 32% in the years covered by the forecast (see Figure 16).

Figure 16. Tax burden



Sources: Statistics Estonia, Eesti Pank

The share of non-tax revenues in the general government budget will fall during this time as the support from the European Union declines. Capital and current transfers from the European Union to the general government were already lower in 2013 than before and are forecast to remain modest in subsequent years. The new budget period for the European Union started in 2014, though experience has shown that the major deployment of financing from Structural Funds will only start a couple of years after the new budget period starts, which is beyond the scope of the forecast.

Budget expenditure

General government expenditure growth dropped sharply to 2.8% in 2013 as capital expenditure was reduced by one sixth. Fewer investments were financed by sales of emissions quotas and the funding from the European Union budget also decreased. Current expenditure grew faster, driven mainly by social spending, which included

pension payments because both the pension index and the number of pensioners rose, and by labour costs. Labour costs were higher because of the wage agreements in health and education, but wages in other sectors rose as well.

General government investment will remain small as a share of GDP and will fall below 4% of GDP in 2016. Government investments are restricted in 2014-2016 because external support will be lower than it was at the peak in 2010-2012. At the end of 2013, 20% of the money from the previous European Union budget period was still left unspent, so the support for the Estonian economy from the Structural Funds could be larger than expected.

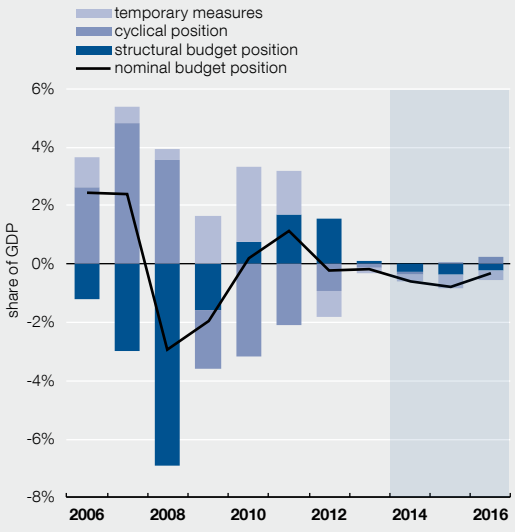
Current spending by the general government is forecast to grow more slowly in 2015-2016, at almost the same rate as tax revenues. The rise in pension expenditure will be restrained by the slower growth in wages and by relatively low inflation, which affects the pension index, while unemployment insurance payments will be smaller as the number of unemployed falls. There will be a temporary acceleration in growth in social transfers in 2015, when it is planned to raise child support and family support.

The ability of the government to limit labour costs and intermediate consumption will be important for the development of its current spending. Personnel costs from the state budget[26] are planned to rise by 4.6% in 2014, but annual growth was 10% in the first quarter. Growth in general government consolidated labour costs has been faster than allowed for in the budget in previous years.

Fiscal balance and debt

The nominal budget deficit in 2013 was 0.2% of GDP. Modest economic growth means that the deficit will increase in 2014 and 2015, but it will improve slightly in 2016 due to the positive impact of the economic cycle (see Figure 17).

Figure 17. General government budget position



Sources: Statistics Estonia, Eesti Pank

The budget of the Estonian general government is forecast to fall into structural deficit in the years covered by the forecast. The structural fiscal position needs to be closely observed because the economic cycle can affect the general government budget significantly, particularly through tax receipts. The effects of the economic cycle and large one-off transactions that do not affect the long-term sustainability of the government budget are removed in the calculation of the structural fiscal position. The methodology used by Eesti Pank shows that the economic environment will have a positive effect on budgetary receipts in the years covered by the forecast[27] and nominal budget balance thereby gives a slightly more optimistic picture of the sustainability of government finances. Budget expendi-

26 Personnel costs from the state budget make up around 60% of all the labour costs of the general government.

27In the methodology used by Eesti Pank, the impact of the economic cycle on the fiscal position is assessed by revenue type. If the cyclical component turns positive, this mainly indicates that tax revenue growth is higher than is sustainable.

ture will grow faster in the forecast horizon than the equilibrium revenue, so there is a risk that general government revenues will not cover expenditures over the economic cycle.

The worsening of the budget deficit is reflected by the easing of the goals in the budget strategy for 2015-2018. At the end of April, the government passed a new budget strategy for 2015-2018 that confirmed the government's medium term objective, MTO, of achieving a structural surplus, but a smaller one than previously planned[28]. As the new State Budget Act does not allow for structural deficits, the new MTO gives less room for error or unforeseen events, and increases the risk that the budget will need to be amended during the budget year.

The aim of keeping the budget structurally balanced is to maintain a sustainable fiscal policy across the economic cycle. At the moment there is more uncertainty than usual surrounding the assessments of the effect of the economic cycle as the revenue bases have grown faster than the economy, and assessments by both Eesti Pank and the European Commission indicate that the Estonian government will not be able to achieve its MTO of a balanced budget without additional measures.

As the nominal deficit can be financed from reserves during the forecast horizon, the general government debt will fall below 10% of GDP. The practice of keeping a balanced budget means that Estonia's sovereign debt is the smallest in Europe. Financing operations and loan guarantees to the European Financial Stability Facility (EFSF) have had more of an impact on the level of debt in recent years than the need to fund the budget deficit has.

28 The Ministry of Finance considers that the effect from the economic cycle on the budget will still be negative in 2015, and will become slightly positive from 2016. As a result they find that there will be a nominal budget deficit in 2014-2015 because of the economic climate, and structurally the budget will be in surplus.

THE BANKING SECTOR AND THE FINANCING OF THE ECONOMY

The funding position of companies will be good throughout the forecast horizon and that of households will improve. The financing position of companies is relatively good and their business operations and investments are not much restricted because of their increased current income, the buffers they have built up, their increased ability to borrow and the low base interest rates on bank loans. Higher incomes and an improved financial position will also increase the ability of households to consume. At the same time, rapidly rising real estate prices will limit the ability of households to invest in residential properties.

Lending

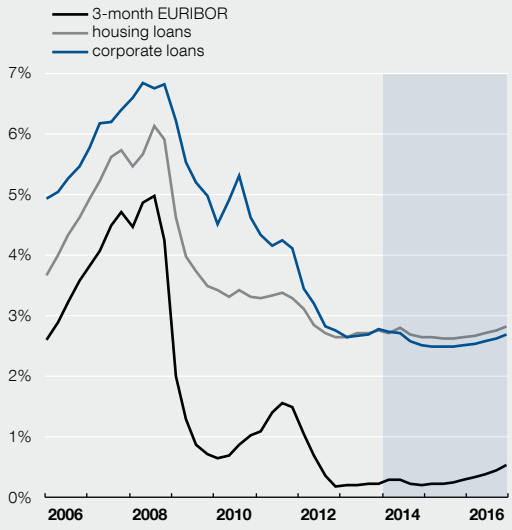
Lending in Estonia is supported by the continued good financial standing of the local banks and the relatively fast growth in deposits from the non-financial sector. Such deposits were growing at the same rate of close to 7% at the end of April 2014 as they had averaged over recent years. Growth in savings 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 loan to deposit ratio of the banking sector, which had fallen noticeably after the crisis, has been at 105% in recent months and growth in household saving will be supported throughout the forecast horizon by the relatively rapid rise in incomes. Corporate deposits will grow similarly, but a lot of companies already have suficient liquidity reserves and therefore the speed of growth in corporate deposits may be braked by an increase in dividend payouts.

Interest rates will remain low throughout the forecast horizon. Although the EURIBOR interbank money market interest rate that serves as the base rate for most loan contracts in Estonia has risen slightly and is expected to rise further in

the second half of the forecast period, it will still remain low by the standards of the past decade throughout the forecast horizon.

Lending conditions and interest margins are not expected to change much in the coming years. Although the ability of banks to finance the non-financial sector has continued to improve, competition between the biggest banks for market share has been moderate. However, loan margins will decline slowly throughout 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 18).

Figure 18. Lending rates



Source: Eesti Pank, European Central Bank

Credit demand

Companies are more and more using their own resources to finance their activities and the need for external capital has fallen as investment is low. Corporate equity grew rapidly in 2013 through reinvested profits and debt liabilities stopped growing at the same time.

Corporate demand for credit will remain low this year and will be moderate in the years to come. Companies have not dared to make large investments in one go because of the uncertainty in the economic climate, and this has reduced the volume of large loans. The average size of loans has shrunk over the past year in most sectors while the number of loans taken has increased, which indicates that most are being used to finance smaller companies and projects. Support for borrowing by small businesses has come from their reduced leverage and from government measures, so their ability to borrow has improved. Demand from companies for credit will be aided in the next few years by moderate growth in investment and a fall in uncertainty. The need for external funds will be reduced by the significantly increased capacity of companies to finance investments using their own resources.

As economic growth returns and investment activity increases, external funding will increase again to some extent. There was a constant increase in borrowing from abroad during the recovery from the economic crisis, but this trend came to an end in the second half of 2013. The inflow of foreign direct investment in equity also declined somewhat in 2013. Lower levels of uncertainty and large new investment projects will raise the share of foreign funding to an extent in the coming years.

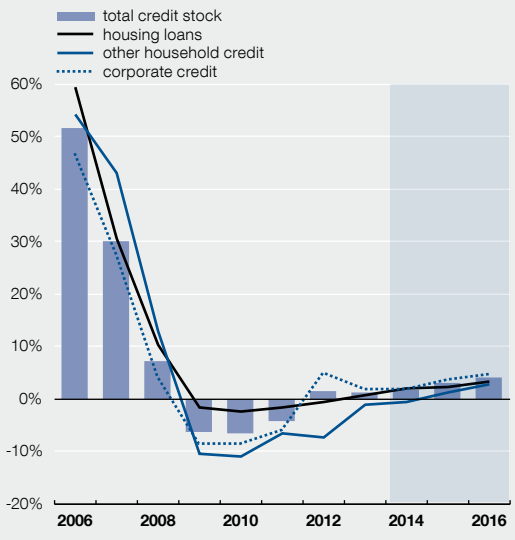
Household credit demand will continue to increase in the coming years, but the loan stock will grow only moderately. In the first four months of 2014, households took out 12% more in loans and leases than a year earlier with 32% more in new housing loans and 1% less in other household loans. Demand for housing loans is backed by rising incomes, the improved financial position of households, low interest rates, relatively high confidence levels and the entry of new borrowers into the

housing loan market. Although the turnover of housing loans has grown rapidly in recent times, the comparison base was low and there is still two thirds less in housing loans being issued now than at the peak of the real estate boom. As the loan stock of households is relatively large, it will continue to grow only moderately in the coming years and will not do so faster than household incomes.

The debt burden of the non-financial sector will shrink throughout the forecast horizon. Annual growth in nominal GDP has reached 6% during the past year, but the annual growth in loans and leases to companies and households stood at only 1.7% at the end of April. Although growth in the loan portfolio will accelerate to the highest level seen during the years following the economic crisis (see Figure 19), it will remain smaller than nominal GDP growth.

Growth in prices of residential properties will remain faster than that in household incomes over the short term, but it is forecast that these rates will harmonise over the coming years. Low interest rates and rising household incomes increase demand for real estate, which has led to rising prices while supply is tight. Rapid price rises may, however, lead to higher expectations for future price rises, with the result that the interest in investing in real estate will rise and households may want to buy real estate properties as quickly as possible as they fear rising prices. However, prices rising faster than incomes will start to make real estate less affordable and so price growth will then slow. Faster growth in real estate prices than in construction costs has raised the profitability of real estate projects, with the result that it has become more attractive to build residential space and the increase in supply will also ease the price pressures caused by supply shortages. The volume of residential construction should also increase in the coming years.

Figure 19. Credit stock growth



Source: Eesti Pank

RISKS

The risks around the outlook for the Estonian economy are mainly related to possible developments in the external environment. The further course of the conflict that started early this year between Russia and Ukraine, and the possible channels for impacts from it, cannot be predicted. There are very many possible negative scenarios that may materialise. Although the impact from the conflict on the Estonian economy has been small so far, any increase in tensions and possible sanctions could cause a setback to Estonian economic growth. As a large part of Estonian goods exports to Russia are re-exports, any fall in Russian demand has a muted effect on the Estonian economy and is mainly felt in a worsening of the outlook for growth in the transportation and storage sector. Alongside the effect on direct trade links with Russia and Ukraine, a larger indirect impact may be felt through other trading partners, notably Finland, Lithuania and Latvia.

Beyond the negative impact through trade channels, any worsening of the recent geopolitical problems could sharply lower confidence among companies and households. If confidence continues to fall and caution to increase, investment projects may be left on hold and saving may increase, and this will then reduce economic activity.

The risks from excessive growth in labour costs have not receded. Although it is forecast that companies will start to correct the speed of rising wage costs this year, it is not impossible that moves to bring labour costs under control will be delayed at the expense of earlier profits. If rising labour costs cannot be balanced by rising productivity, this will start to threaten the capacity for export growth and the ability of companies to compete on price in foreign markets will worsen. The longer a correction in labour costs is postponed, the sharper and deeper that correction will have to be. As long as statistics do not show wage growth and productivity growth coming into line, the public sector will need to avoid driving wage growth, as that would make adjustment of the growth in wages in the private sector harder. If there is a correction in wage growth in the private sector, the public sector needs to be ready for it to slow there too.

If demand for residential properties is based on excessively optimistic expectations, the recent rise in real estate prices could continue in the near future. Purchases of residential properties in expectation of price rises could lead to a repeat of the developments in the last real estate boom and to the consequential bursting of the bubble. The financial sector is better protected than during the previous boom as Eesti Pank has clearer responsibility for macro financial supervision from 2014 and has the legal right to set capital and other requirements for commercial banks in order to reduce risks. If households are guided by excessive optimism in their expectations for prices, then they could face unmanageably large debts and falling asset prices if demand levels off followed by a fall in real estate prices.