# Estonia



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*The economic slowdown has been milder than in most European economies. This has helped to limit the dent in the country's strong public finances, although several fiscal metrics will continue to worsen in 2021. The longer-term outlook for the economy and for the key country risk metrics has not been materially affected by the downturn.*

## Country Risk Analysis

### *Recent economic developments*

**Economy contracted less than most peers.** Real GDP contracted 2.9% last year. Relatively resilient household spending, on the back of a relatively mild pandemic spreading, together with resilient goods exports helped make the downturn less severe than most other similarly rated countries. The cooling of activity and temporary tax cuts pushed inflation into negative territory in 2020. More recently, consumer prices have been rising, in line with inflation in the euro area.

**Labour market conditions worsened and wage growth moderated**. The unemployment rate which had started to rise already before the pandemic, increased to 6.8% last year. The upsurge was larger than in most economies in the region. In parallel, employment dropped sharply and is expected to decline further this year. The labour market is efficient by most measures, displaying a significant two-way flexibility of wages which normally has worked well as a buffer against shocks. Accordingly, average wage growth slowed last year, hand in hand with the rise in unemployment. The increase of 2.9% compares to the average pace of 7% in the five years prior to the pandemic. The pace of unit labour cost (ULC) growth also slowed, reducing concerns over the possible loss of competitiveness.

**Demographic challenges remain in check**. Wage pressures over the past years have been driven by rapid economic growth in combination with a shortage of labour. The previous decades' declining population trend was halted in 2015, helped by net migration turning positive. Migration flows were positive in 2020 too, but this has not stopped the working age population from a continued decline. United Nations projections are for a continued decline of around 2.5% per year over the next decade.

Although labour costs continued up last year, the long-standing threat to an open economy such as Estonia's of losing competitiveness, still remains mostly a threat. Data, including from the European Commission, indicate that the country continued to gain export shares in 2020. Overall trade fell only moderately, helped by the fact that the downturn among Estonia's main trading partners was slightly shallower than in most other European economies. After staying positive for most of the past decade the current account shifted into negative last year, partly due to a single business transaction involving imports of computer services. Meanwhile, foreign direct investment (FDI) as a share of GDP was broadly stable at healthy levels.

**Strong external position.** A long series of current account surpluses has contributed to a strong external creditor position. The country was a net external creditor in 2020 too and the net international investment position improved as a share of GDP. Gross external debt as a share of GDP has been on a declining trajectory since the global financial crisis, mainly due to deleveraging in the private sector. In 2020, however, the contracting economy produced a rise in the ratio to about 89% of GDP. The debt is mostly held by the private sector. Roughly 45% is short term.

## *Economic policies*

**Fiscal policy response to crisis led to rising budget deficit.** A long track record of strong public finances remains a key supporting factor for country risk. This is much due to a strong fiscal framework, including the fiscal rule, which increases transparency and predictability. Last year, expenditures rose on the back of a moderate stimulus package and the workings of automatic stabilisers. The cost for wage subsidies in particular made a significant impact. This raised the general government budget deficit to 4.8% of GDP. Although the deficit was the highest on record, it was better than budgeted.

**Deficit to continue up despite tax incomes from the pension reform**. Continued support measures, including wage subsidies, are likely to lead to a further rise in the general government budget deficit in 2021 to 5.5% of GDP. This is despite an expected boost to tax revenues generated by the controversial pension reform which enables people to withdraw their 2$^{nd}$ pillar pension savings. Although the reform may be positive for the short-term fiscal outlook (and growth), most observers have cautioned that the new right for savers to withdraw from the self-funded second-pillar of the system could threaten the adequacy of pensions in the longer-term. In 2022, a marked fiscal consolidation is likely.

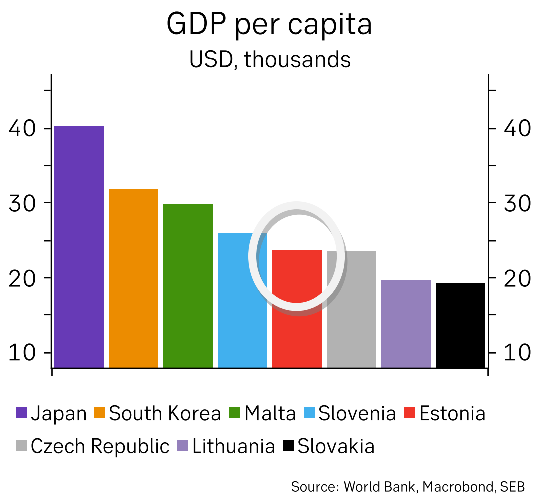
**Government debt edges up**. Estonia's strong fiscal position enabled it to respond to the coronavirus shock without jeopardizing debt sustainability. Gross government debt rose to 18.8% of GDP from 8.4% in 2019. This is the highest level on record, but still among the lowest of all countries that we cover, and significantly below what many had forecasted at the outbreak of the pandemic. Debt issuance, including a EUR 1.5 bn eurobond, well exceeded the government's financing needs for 2020 thus contributing to raising available liquid assets. The government holds liquid financial assets in various fiscal reserve funds such as the liquidity reserve. These assets rose to more than 12% of GDP in 2020. Consequently, government net debt is very low. The gross debt/GDP ratio is expected to continue up in the next couple of years.

**Banking sector stable and broadly sound.** Most aggregate financial soundness indicators of the Nordic dominated banking sector are strong. Capitalization is among the highest in the EU while the share of non-performing loans was among the lowest going into the pandemic. The share of non-resident deposits has edged up over the past year but remains low. The share of these deposits originating from outside the EU is marginal.

## *Economic and institutional structures*

**High quality governance and institutions.** Most World Bank governance indicators are stronger than peers and have improved over the past couple of years. The uncovering of money laundering cases in the financial sector over the past decade have raised questions regarding the quality of financial supervision. However, most observers have concluded that the authorities' swift response has been a testament of high institutional strength. The authorities are continuing to strengthen capacity in the area, for example by strengthening supervision. They also recently transformed the Financial Intelligence Unit (FIU), one of the main bodies for preventing money laundering, to an independent institution under the jurisdiction of the Ministry of Finance. On the business climate, the World Bank's Ease of Doing Business index reflect a more favourable environment in Estonia than in most country risk peers, although inferior to peers such as Lithuania and South Korea.

**Relatively low incomes per capita weigh on country risk**. GDP per capita naturally fell last year but the trend over the past decade has seen income levels catch up with richer peers. Adjusted for purchasing power, GDP per capita as a share of average in the EU rose to 83% in 2019, a ratio which (all else equal) automatically rises when excluding the richer UK which has left the union. Per capita incomes are still low compared to similarly rated economies. This weighs on country risk.




## *Political developments*

**New governing coalition.** A new government coalition came to power in early 2021 following investigations of alleged corruption among representatives in the previous government. The new coalition consists of centre-right Reform party (ER) and centre-left Centre party (KESK) with the former prime minister. The coalition, headed by new prime minister Kaja Kallas of ER, has declared their continued strong support for the EU and NATO. Most observers expect the government returning to more "normality", including the long-standing tradition of fiscal prudence and facilitating a favourable business climate. The next parliamentary election is due in March 2023.

## *Outlook*

**Economy on gradual and uncertain recovery path.** The economic outlook is uncertain, like for most economies, as the evolution of the pandemic is unpredictable. New social restrictions as of March 2021 caused some uncertainty as to whether the recovery would be delayed. Nevertheless, we expect an acceleration in real GDP growth to 3.3% in 2021. The central bank forecasts 2.7%, rising to 5% in 2022.

**Stable longer-term growth trajectory**. The risk that the pandemic generated downturn may have made permanent damage to the country's medium term growth potential is low. The limited extent of the downturn point in this direction. Instead, growth is expected to revert towards 3% by 2024. EU funded investment activity will provide an important boost to growth over the medium-term. The government plans to step up the utilisation of EU funds, where significant amounts are still available under the previous multi-annual financing framework (MFF). In addition, disbursements from the EU's pandemic recovery fund, Next Generation EU (NGEU), should mean that previous expectations of declining EU funding during the current MFF period (2021-2027), due to Estonia's higher income levels, will probably prove wrong. Expectations are that disbursements from the new MFF will start in 2022 and that NGEU funds are likely to peak in 2022-2024. Depending on the specific investments made, hopes are that these funds could raise productivity growth to compensate for factors such as an aging population.

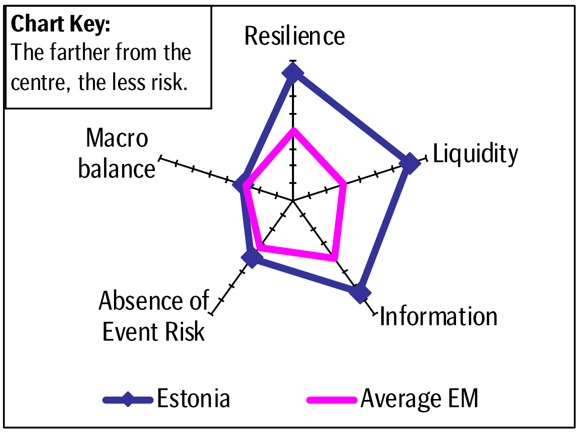
**Risks to the recovery**. On the domestic side, there is a risk that the recovery will be more gradual than in our main scenario, for example if the pandemic prevails so that the start of the tourism season will be delayed. On the external side our macro scenario includes the risk that the recovery in the euro area could be more drawn-out as pandemic related restrictions have been tightened recently. Weaker than expected demand in the region, including tourism from Finland, would lead to lower exports and slower than forecasted GDP growth, and could push the current account into deficit.

**Geopolitical risks are important**. Geopolitical tail risk remains important given Estonia's proximity to Russia and its large ethnical Russian population. Security tensions in the region could rise to such levels that they affect sentiment and economic activity negatively. This being said, Estonia has proven resilient to a range of political and economic developments in Russia. Some view the US' strengthened commitment to NATO as positive for the security situation in the region. The country is still largely dependent on Russia for its gas needs. However, supply from other sources have risen over the past few years. In 2020 a gas pipeline opened between Estonia and Finland. This year, the expected completion of a gas pipeline between Poland and Lithuania should further improve energy security in the Baltic region.

**Labour supply constraints poses downside risks.** Most likely, labour market conditions will become tight again as soon as economic activity picks up. Consequently, the shortage of labour is likely to return as a risk to economic growth. For example, shortages may lead to a longer period with wage increases surpassing productivity growth. This could ultimately lead to a loss of competitiveness, and hence pose risks to economic growth and to the current account balances.

## Estonia: Risk Profile

| Key Indicators | 2021 |
|---|---|
| Population (millions) | 1,3 |
| GDP/capita (USD) | 26 286 |
| Real GDP (% chg) | 3,3 |
| Inflation (%) | 1,5 |
| Current Account Balance (% of GDP) | 0,8 |
| Reserves/imports (months) | 0,4 |
| Budget balance (% of GDP) | -5,5 |
| Government debt (% of GDP) | 21,5 |




| External ratings: | Peers: |
|---|---|
| Fitch: AA- / Stable | South Korea |
| Moody's: A1 / Stable | Chile |
| S&P: AA- / Stable | Japan |

**Graph:** Estonia outperforms the average score of our emerging market economies on all counts.

## Estonia: Key Economic Indicators

| **Macroeconomic** | **2017** | **2018** | **2019** | **2020** | **2021** | **2022** | **2023** | **2024** |
|---|---|---|---|---|---|---|---|---|
| GDP (USD bn) | 27,0 | 30,6 | 31,5 | 31,0 | 35,0 | 38,1 | 41,1 | 44,1 |
| GDP/capita (USD) | 20431 | 23127 | 23706 | 23313 | 26286 | 28571 | 30851 | 33185 |
| GDP (change) | 5,2% | 4,3% | 5,0% | -2,9% | 3,3% | 4,5% | 3,5% | 3,2% |
| Investments/GDP | 26% | 25% | 27% | 32% | 31% | 30% | 30% | 29% |
| **Government Finances** | | | | | | | | |
| Budget balance/GDP | -0,4% | -0,6% | -0,3% | -4,8% | -5,5% | -3,5% | -1,1% | -0,7% |
| Govt debt/GDP | 9,3% | 8,2% | 8.4% | 18,2% | 21,5% | 24,5% | 24,5% | 24,5% |
| **Money & Prices** | | | | | | | | |
| CPI inflation (%) | 3,7 | 3,4 | 2,4 | -0,6 | 1,5 | 2,3 | 2,1 | 2,1 |
| Money, M2 (yoy change) | 6% | 10% | 10% | 19% | 10% | 8% | 6% | 5% |
| Interest rates, short-term | -0,3% | -0,3% | -0,4% | -0,4% | -0,5% | -0,4% | -0,4% | -0,2% |
| Exchange Rate (EUR/USD) | 0,9 | 0,8 | 0,9 | 0,9 | 0,9 | 0,8 | 0,8 | 0,8 |
| Oil price (USD/barrel, Brent) | 54 | 71 | 64 | 42 | 62 | 60 | 60 | 61 |
| **Balance of payments (USD, bn)** | | | | | | | | |
| Exports of goods | 19,3 | 20,1 | 21,4 | 20,2 | 21,3 | 22,0 | 22,6 | 23,5 |
| Imports of goods | 17,9 | 18,4 | 19,5 | 20,2 | 20,3 | 20,9 | 21,0 | 21,8 |
| Current account | 0,6 | 0,3 | 0,6 | -0,4 | 0,3 | 0,4 | 0,5 | 0,7 |
| as % of GDP | 2,3 | 0,9 | 2,0 | -0,9 | 0,8 | 1,1 | 1,3 | 1,5 |
| FDI, net | 1,1 | 1,4 | 1,1 | 3,0 | 3,4 | 3,6 | 3,9 | 4,2 |
| Loan repayments | -3,3 | -3,5 | -3,3 | -3,5 | -3,6 | -3,7 | -3,9 | -4,0 |
| Net other capital | -1,4 | -1,5 | -0,9 | 0,3 | 1,9 | 1,6 | 1,5 | 1,2 |
| Balance of payments | -3,0 | -3,3 | -2,6 | -0,6 | 2,0 | 2,0 | 2,1 | 2,1 |
| Reserves | 0,2 | 0,7 | 1,3 | 1,9 | 2,1 | 2,2 | 2,3 | 2,4 |
| External debt | 19,6 | 19,8 | 19,9 | 20,2 | 20,5 | 20,9 | 21,3 | 21,8 |
| o/w short term debt | 8,6 | 8,7 | 8,7 | 8,8 | 9,0 | 9,2 | 9,3 | 9,6 |

*Sources: Oxford Economics, SEB and IMF*

| **Rating history (eoy)** | | | | |
|---|---|---|---|---|
| Fitch | A+ | A+ | AA- | AA- |
| Moody's | A1 | A1 | A1 | A1 |

| | |
|---|---|
| **Type of government:** | Parliamentary democracy |
| Next elections | Parliamentary 2023, Presidential 2021 |
| **Other:** | |
| Latest PC deal | None |
| Latest IMF arrangements | 2000, SBA |