ESTONIA

Economic growth is projected to rise significantly in 2017 and to exceed 3% in 2018. Domestic demand will strengthen, sustained by public and private investment. Household spending is set to slow as inflation will resume and cut into slow nominal income gains.

The fiscal stance is projected to ease in both 2017 and 2018. The authorities plan to use the fiscal room created by past budget surpluses, very low public debt and favourable borrowing conditions for additional spending on infrastructure and education. To make growth more inclusive, measures to further reduce taxes on low-wage earners and to support the employability of jobseekers would be welcome.

Estonia's successful integration into global trade has contributed to strong growth since independence. However, the high vulnerability to external shocks that comes with openness has tended to affect vulnerable groups disproportionally. The social safety net and labour-market policies have been strengthened to address this issue, but a further improvement of the coverage and the targeting of social programmes would make growth more inclusive.

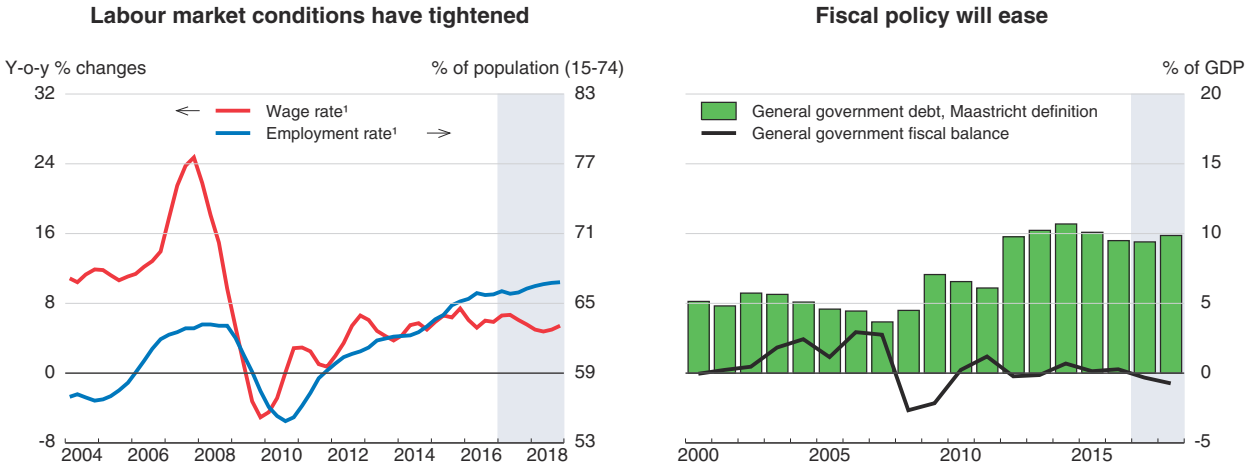
Economic activity has strengthened

GDP growth surprised on the upside in the second half of 2016, and business services, notably in the ICT sector, have been particularly strong. The oil shale industry has benefited from the upturn in energy prices, but the transport sector has been hit by lower goods transit from Russia. Private consumption has remained robust, sustained by the strong labour market. Wage growth, while moderating, has continued to exceed productivity gains.

Fiscal policy is supportive

The fiscal stance is expected to turn expansionary in 2017-18. Public investment will rise in 2017, sustained notably by EU structural funds. In 2018, the government intends to

Estonia



1. Four-quarter moving average.
Source: OECD Economic Outlook 101 database.

StatLink http://dx.doi.org/10.1787/888933503016

Estonia: **Demand, output and prices**

	2013	2014	2015	2016	2017	2018
	Current prices EUR billion	Percentage changes, volume (2010 prices)				
GDP at market prices	18.9	2.7	1.5	1.7	2.6	3.1
Private consumption	9.7	3.4	4.8	4.0	2.9	4.1
Government consumption	3.6	2.5	3.4	1.2	2.2	1.4
Gross fixed capital formation	5.1	-6.9	-3.7	-2.6	6.4	5.1
Final domestic demand	18.4	0.4	2.3	1.9	3.5	3.7
Stockbuilding[1]	0.1	2.4	-1.5	0.9	1.0	0.0
Total domestic demand	18.5	3.0	0.8	3.0	4.8	3.7
Exports of goods and services	16.0	3.1	-0.6	3.6	3.8	3.9
Imports of goods and services	15.6	2.2	-1.4	4.8	4.7	4.7
Net exports[1]	0.4	0.8	0.6	-0.7	-0.5	-0.5
Memorandum items						
GDP deflator	_	1.9	1.0	1.5	4.0	2.9
Harmonised index of consumer prices	_	0.5	0.1	0.8	3.2	2.8
Private consumption deflator	_	0.5	0.0	0.8	3.2	2.8
Unemployment rate	_	7.4	6.2	6.8	7.6	8.4
General government financial balance[2]	_	0.7	0.1	0.3	-0.4	-0.7
General government gross debt[2]	_	14.1	13.0	13.1	13.0	13.4
General government debt, Maastricht definition[2]	_	10.7	10.1	9.5	9.4	9.8
Current account balance[2]	_	0.9	2.2	2.7	1.8	1.3

1. Contributions to changes in real GDP, actual amount in the first column.
2. As a percentage of GDP.
Source: OECD Economic Outlook 101 database.

StatLink http://dx.doi.org/10.1787/888933505809

change the strict fiscal rule of a balanced budget in structural terms and to spend more on infrastructure, health care, education and family benefits. The planned fiscal stance is appropriate given Estonia's robust public finances and spending needs. Nevertheless, infrastructure projects require careful selection to ensure a good social return on investments.

The authorities plan to make the tax mix more progressive and competitive. A cut in the income tax rate on distributed profits should improve the country's attractiveness for investors. A significant increase in the personal income tax allowance in 2018 will boost the purchasing power of households and might help to moderate increases in salaries. Nevertheless, growing tensions in the labour market will maintain wage growth above productivity growth. Firms, whose profitability is already affected by rising labour costs, will likely hire less and increase capital investment. But higher costs will reduce international competitiveness and limit gains in export market shares.

By conditioning the receipt of benefits to job-search activity, reform of the disability pension scheme will increase labour supply. However, despite activation and rehabilitation measures in place, a significant share of those with reduced work capacity are unlikely to find a job, thereby increasing the unemployment rate and requiring additional resources to improve their employability. To stimulate job creation for workers with low productivity, further targeted cuts in social security contributions on low-wage earners would also be appropriate.

Growth will pick up driven by domestic demand

GDP growth is projected to gain momentum and exceed 3% in 2018 on the back of stronger investment in the public and the private sectors. Exports should grow in line with recovering foreign markets and will require increasing production capacity. Imports will grow strongly because of the relatively high import intensity of investment. Increases in excise tax rates and wage growth will push up inflation. Consumption will remain strong, supported by accommodative tax measures.

Risks to the projections relate to trade developments in the Baltic region. Escalation of tensions with Russia or a weaker recovery in Finland would undermine investment. By contrast, stronger growth in Europe, and in the Nordic countries in particular, could push exports higher. Domestically, the pick-up in public investment is uncertain as a number of public infrastructure projects are not ready yet. Wage pressure could ease, should the labour market reforms be more effective than assumed. If firms' difficulties in recruiting diminish and their profitability recovers, investment and growth could be stronger than projected.