The Estonian Economy and Monetary Policy

Eesti Pank
EUROSÜSTEEM

3 / 2024

The Estonian Economy and Monetary Policy is an Eesti Pank review released four times a year that summarises the main recent events in the global and Estonian economies. The review also contains an economic forecast for Estonia.

The Estonian Economy and Monetary Policy is available at
https://www.eestipank.ee/en/publications/estonian-economy-and-monetary-policy
and is free of charge to subscribers.

Information by telephone on +372 668 0998,
or by fax on +372 668 0954

or by email from trykis@eestipank.ee.

Review by	Rasmus Kattai, Gerda Kirpson, Helen Ljadov, Lauri Matsulevitš, Kaspar Oja, Sulev Pert, Mari Pärnamäe, Sirje Rank, Taavi Raudsaar, Mari Rell, Heili Saia, Orsolya Soosaar, Birgit Strikholm, Anita Suurlaht-Donaldson, Katri Urke, Nils Vaikla.
Online	ISSN 2504-6012
Layout and design	Urmas Raidma

CONTENTS

INTRODUCTION 4

THE EXTERNAL ENVIRONMENT 5

The global economy 5

The euro area 7

Box 1: Monetary policy in the euro area 9

Trading partners 11

THE ESTONIAN ECONOMY 13

Economic activity 13

Domestic demand 15

external balance and competitiveness 16

The labour market 19

Prices 21

Box 2: Differences in inflation rates across the components of core inflation 22

General government financing 23

THE EESTI PANK ECONOMIC FORECAST FOR 2024-2026 25

The international economic environment 25

Technical assumptions used in the forecast 26

Economic growth 27

Prices 30

The fiscal position of the general government 30

Additional scenario to the forecast:
The outlook for the economy if the new coalition agreement is fulfilled 30

INTRODUCTION

The global economy has held its course towards growth. The global economy continued to grow in the first half of the year despite monetary policy being tighter. One driver of growth has been the positive impact that falling inflation has had on purchasing power and consumption, in combination with the resilient performance of the labour market. The euro area economy has in contrast proved softer than expected, and the outlook for growth in it has been adjusted to be a little weaker. The lowest point for the economy was reached however last year and the year before, and it is expected that the main target markets for both the euro area and Estonia will grow in future, which should boost the exporting branches of the economy that have faced difficulties.

The Estonian economy has steered towards recovery. Several sectors that have been in difficulties have started to show signs of improvement. Output volumes in several branches of manufacturing that had been declining have started to grow again. Export volumes from Estonia grew in the first half of this year, albeit by only a little. The revival of foreign markets together with the improved competitiveness and lower cost pressures reported by Estonian companies point to exports of goods and services continuing to grow. Lower interest rates are also expected to provide relief, as the cuts in rates will pass through to borrowers in Estonia faster than they will in most other countries in the euro area, like the earlier rises in rates did. In line with this, branches of manufacturing that have not yet seen improvement have expressed the expectation of increases in output volumes.

Economic activity will increase slowly. Growth in foreign markets will provide additional impetus to growth in the economy as opportunities for exports improve, but the growth in purchasing power in Estonia's main export markets will not be very fast. Equally, the growth in the real purchasing power of people in Estonia will be quite sluggish, as the changes to fiscal policy decided on by the government will cause income tax rates to rise, while higher indirect taxes will raise the price level. Spending on private consumption, which will provide around half of the growth in the economy, may leak out of Estonia to a larger extent than before, as the high price level of consumer goods has already led domestic retail sales to lose ground to online stores based abroad. Reducing the budget deficit will mean the general government making a smaller contribution to the economy, and will consequently also mean slower growth in the economy in the years ahead. Growth is expected to be around 2% next year, and 3% in 2026.

The labour market is adapting to the new circumstances. The labour market has resisted very well against the recession that has dragged on for more than two years by now, as the rise in unemployment has been relatively small, and wages have risen enough at the same time for real incomes to have returned by now to the level they were at before high inflation took off. The structural problem in the Estonian economy has been the shortage of qualified labour, and unemployment did not rise higher because employers held on to their staff, and so the underemployment of workers means that employment is not expected to increase rapidly in the first years of growth in the economy, and nor will unemployment fall.

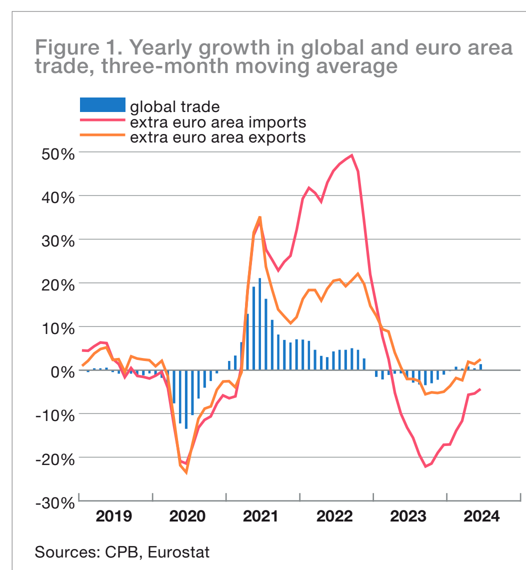
Tax rises mean that inflation will not fall. The consumer basket will rise in price by 3.5% this year, and inflation can be expected to be at a similar level in the next two years. The ability of companies to raise their prices is limited, but they may try to do so in order to recover some of the profitability they have lost in the meantime. The price level in Estonia has reached the average of the European Union while incomes are at three quarters of the European Union average, and so the rate of additional growth in purchasing power indicates the demand environment will be generally weaker in the coming years.

THE EXTERNAL ENVIRONMENT

THE GLOBAL ECONOMY

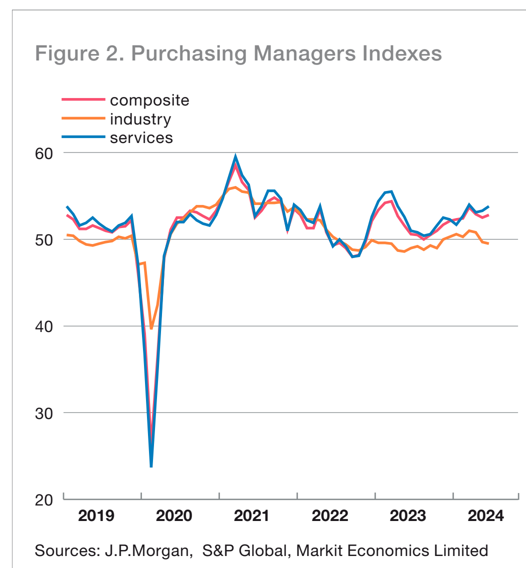
The global economy continued to grow in the second quarter. Stable growth continued around the world despite the tight financing conditions and geopolitical tensions. Inflation falling around the globe has improved the real purchasing power of consumers. Asia was the region with the fastest growth, while Europe and low-income emerging economies had the slowest. Growth in the US economy remained strong, while the economy in the United Kingdom grew by 0.7% over the quarter (see Table 1). Growth has slowed in the US economy throughout the past year though, as high interest rates have increasingly affected economic activity. Economic growth slowed a little in the second quarter in both the euro area and the United Kingdom, while the Japanese economy exceeded market expectations by growing by 0.7% over the first quarter. The growth came mainly from increased private consumption, which was aided by the largest rise in wages of the past 33 years, which was agreed during the spring wage negotiations. Growth was strong in global trade in the second quarter (see Figure 1) as companies started to stock up on goods for Christmas earlier than usual this year, probably in fear of worsening trade tensions.

Figure 1. Yearly growth in global and euro area trade, three-month moving average



Sources: CPB, Eurostat

Figure 2. Purchasing Managers Indexes



Sources: J.P.Morgan, S&P Global, Markit Economics Limited

Growth in the global economy remained moderate at the start of the third quarter as well, though the outlook for the industrial sector has deteriorated. The composite purchasing managers index (PMI)[1], which measures global economic activity, stood at 52.8 points in August (see Figure 2). Economic activity was supported by the services sector, which has grown strongly in the past year and a half, powered by financial services. It was of note that the PMI showed global activity in the industrial sector falling in August for the first time since December.

Table 1. GDP growth in different regions in 2019- 2024 (change, %)*

	2019	2020	2021	2022	2023	Q1 2024	Q2 2024	2024
World	2.9	-3.1	6.0	3.4	3.2			3.2
Advanced economies	1.7	-4.5	5.2	2.7	1.6			1.7
Emerging markets and developing economies	3.7	-2.1	6.6	4.0	4.3			4.3
Euro area	1.6	-6.1	5.3	3.5	0.4	0.5 (0.3)	0.6 (0.2)	0.9
United States	2.3	-2.8	5.9	2.1	2.5	2.9 (0.4)	3.1 (0.7)	2.6
China	6.0	2.2	8.1	3.0	5.2	5.3 (1.5)	4.7 (0.7)	5.0
Japan	-0.4	-4.3	2.1	1.0	1.9	1.2 (-0.6)	-0.2 (0.7)	0.7
United Kingdom	1.7	-11	7.6	4.1	0.1	0.3 (0.7)	0.9 (0.6)	0.7

* GDP at constant prices, quarterly growth over the previous quarter is in brackets
Sources: IMF World Economic Outlook Update (July 2024), OECD, Eurostat, National Statistics; 2024 is IMF forecast

1 S&P Global Composite PMI. A seasonally adjusted figure for the index of 50 points or more indicates an increase in production from the previous month, while a figure below 50 points indicates production falling.

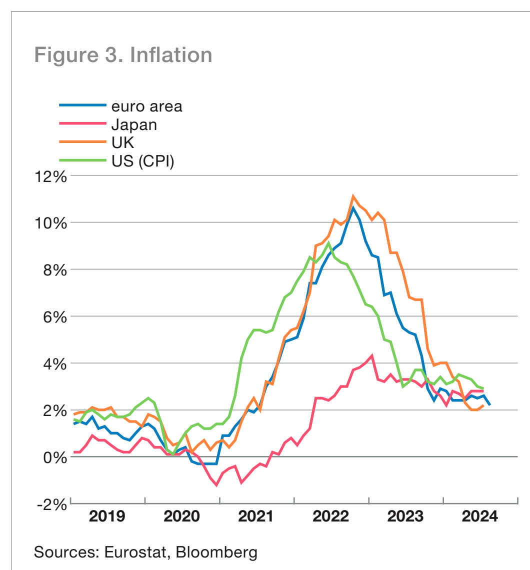
The outlook for the industrial sector deteriorated in several industrialised countries, including the USA, Canada, Germany and Brazil. Corporate estimates for production volumes and for the outlook for new orders have become worse. Reduced demand and a sharp increase in warehouse stocks caused US industrial companies to cut their output volumes in August for the first time this year for example.

Lower inflation allowed central banks to start cutting base interest rates. Inflation around the world has decelerated mainly because prices of goods have risen more slowly, at around the rate from before the pandemic. Inflation has still fallen more slowly than was earlier forecast by international financial institutions, mainly because inflation has been high for services with support from continuing fast growth in wages in several advanced economies. Lower aggregate inflation (see Figure 3) allowed the Bank of England, the Bank of Canada and the European Central Bank to start the cycle of cuts in base interest rates. The Federal Reserve in the US is keeping base interest rates at their recent high levels, but the disappearance of the factors causing inflation allowed it to cut base interest rates by 50 basis points in September. Particular attention has been focused of late on the US labour market, where the number of job openings has fallen to the lowest level since the start of 2021.

Unemployment remains low at the same time though at 4.3%, while employment has continued to increase, and so it is more a question of tensions easing in the labour market than of the labour market cooling sharply. The Japanese central bank is going against the trend of the other large central banks as it raised its base interest rate to 0.25% at the end of July, which is the highest rate of the past 15 years.

The emerging economies where economic growth was fastest in the second quarter were India, China, Brazil and Indonesia. Growth in the Indian economy stood out particularly, as it reached 7.6% over the year. The growth in the Indian economy has been supported by general government spending, and the positive impact has passed through into other sectors of the economy. The result has been strong growth in the industrial and services sectors, which has balanced out the weakness in agriculture. The Chinese economy grew by 4.7% over the year in

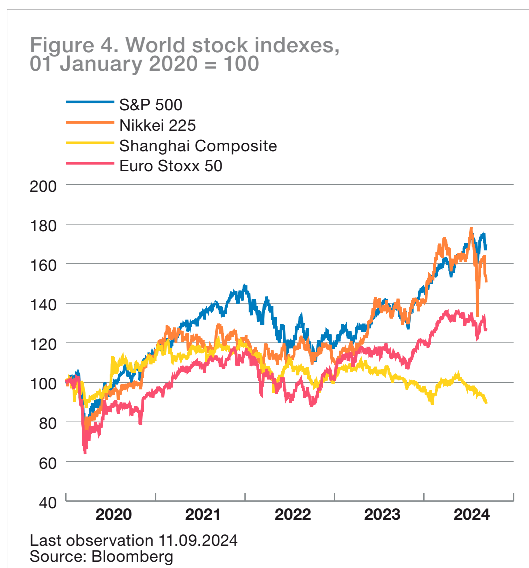
Figure 3. Inflation

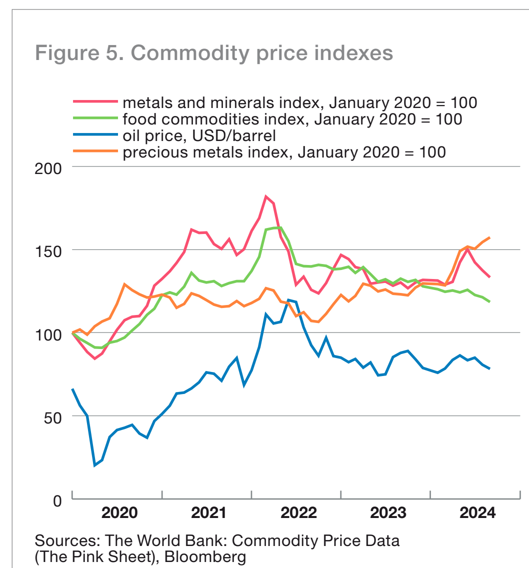


Sources: Eurostat, Bloomberg

the second quarter, which is a little below market expectations and below the GDP growth in the first quarter. Growth in the Chinese economy is supported mainly by goods exports and general government investment in infrastructure projects, while poor retail sales and almost non-existent inflation reflect the weakness of domestic demand. Demand has been weak mainly because real estate prices have fallen, and a lot of people in China have put their savings into real estate. The PMI for industrial companies in Asian countries rose in August, in contrast to that in the rest of the world, and did so most in India, Vietnam and Thailand. Lower inflation has allowed central banks in several emerging economies like Brazil, Mexico and Peru to cut their base interest rates quite deeply, but there is increased caution about any further cuts, as the gap between those interest rates and those of the Federal Reserve can prompt capital outflows and the depreciation of local currencies against the US dollar.

Global financial markets were volatile at the end of summer. Markets received an unpleasant surprise when financial results for the second quarter of large US technology companies were worse than expected, on top of which the Japanese central bank raised its monetary policy interest rate quite unexpectedly and quite steeply. This caused large-scale exits from the previously very popular carry trade positions in the Japanese yen that led the Nikkei index in Japan to lose 12% in one day (see Figure 4). The volatility in stock markets on 5 August even reached the peaks seen during the Covid-19 crisis and the financial crisis of 2008. All the other main equity indexes also fell, and





though they later recovered and calmed down, volatility has remained greater than usual. US labour market data received in August were weaker than expected and the focus moved more from inflation to developments in the US labour market. Market expectations consequently increased that the US Federal Reserve would decisively loosen its monetary policy this autumn, and there was consequently a large wave of purchases in bond markets. Yields on European sovereign bonds mainly fell across the whole yield curve.

Prices in commodities markets moved in different directions. The price of Brent crude oil fell back to where it was at the start of the year, and by the beginning of September it was at 69 dollars a barrel (see Figure 5). The price fell primarily because demand was down as a consequence of continuing problems in the Chinese economy and weaker economic indicators from the US. Speculation also spread that OPEC+ may postpone further its planned decision to increase oil production in October. Production is currently being maintained at 5.9 million barrels a day, but there are some OPEC members who have indicated that they are planning to increase production. The price of gold rose in August to another all-time record level at 2531 dollars an ounce. Prices of agricultural commodities have generally fallen, and the price of wheat was at its lowest level for a year in August, having lost around 30% from its peak. Prices of industrial metals like aluminium and copper have been volatile, but the general trend has been downwards[2].

THE EURO AREA

Growth in the euro area economy slowed in the second quarter. GDP was 0.2% larger than in the previous quarter and the growth came largely from net exports and general government expenditures, while investment continued to decline. The support for the economy that was hoped for from private consumption did not materialise, even though falling inflation, looser monetary policy and strong growth in wages have improved the purchasing power of consumers, and the state of the labour market in the euro area remains very good for employees. The performance of Germany, the largest economy in the euro area, continues to cause concern. The German economy contracted by 0.1% over the quarter in the second quarter, while investment, private consumption and net exports were all down. The continuing slump in the German production sector points to the structural problems in that country's energy-intensive industrial sector that are hampering the recovery of both the German economy and the economy in the rest of the euro area. Growth in the Spanish economy remains strong meanwhile at 0.8% with the impetus coming from the services sector, while moderate growth rates of 0.3% in France and 0.2% in Italy were seen in the second quarter.

The paths of the industrial and services sectors in the euro area are diverging further and further from one another. The composite PMI for August[3] shows the euro area economy continuing to grow in the third quarter, and the composite

2 World Bank Commodities Price Data (The Pink Sheet).

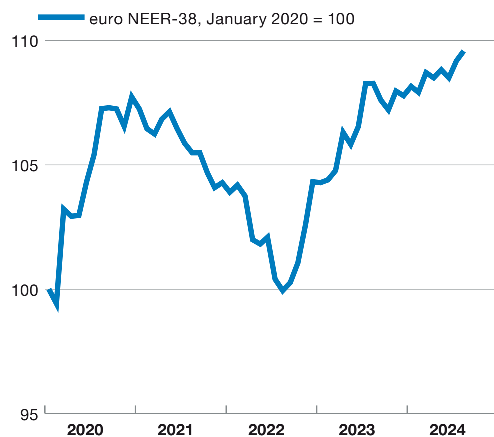
3 The HCOB Eurozone Composite PMI rose to 51 points in August.

index for the euro area has now remained above 50 points for six consecutive months. The primary driver of the increased economic activity was the support given by the Olympic Games in Paris to the French services sector, and the entry of new companies into the euro area services sector. Although the PMI for the industrial sector strengthened a little in August, it still remains well below the 50-point mark. This shows how the production sector in the euro area has stalled and business conditions have been deteriorating there for several months by now. The decline in new orders has been greatest since December last year, and foreign demand for products from the euro area has weakened at an accelerating rate this year according to the PMI surveys. The employment index[4] was also below the 50-point threshold in August for the first time since the start of 2021, indicating a fall in the number of jobs.

The industrial sector in the euro area is performing poorly partly because of changes in consumer preferences after the pandemic, as consumption switched from goods to services instead, but it is also partly because of the ever-increasing decline in competitiveness as new technologies are introduced more slowly and arduously than in China or the USA.

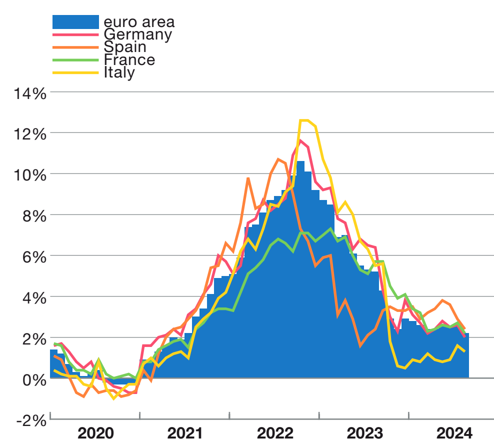
The decline in industrial output and retail sales volumes has confirmed the economy is slowing. Industrial output in the euro area fell by 0.3% in July, which made several consecutive months of decline, with the fall over the year at 2.2%. The decline has been largest in chemical production, textile production and wood production, and also in furniture production. Trade in goods was again in surplus in the euro area in July, as the growth in imports over the year was 4% while the growth in exports of goods was 10.2%. The main trading partners from which imports have fallen of late have been Japan, the USA and the United Kingdom, while exports have increased the most to Japan, the USA and Norway. The exchange rate of the euro (NEER) appreciated again against the currencies of key trading partners after a short depreciation at the start of summer, partly because cuts to US monetary policy interest rates were put on hold, creating a differential in interest rates in the euro area and the USA (see Figure 6). This has made companies in the euro area even less competitive. Financing conditions in the euro area will however ease moving forwards, creating conditions that will

Figure 6. Trade-weighted euro exchange rate



Source: European Central Bank

Figure 7. HICP inflation



Source: Eurostat

favour investment (see Box 1). Retail sales volumes in the euro area increased a little in July over the month as sales of food increased, but sales of fuels fell further. Retail sales volumes in the euro area continue to be down in yearly comparison.

Inflation in the euro area slowed from 2.6% in July to 2.2% in August. This was the largest fall in inflation since July 2021 (see Figure 7). It was partly a consequence of energy prices being sharply lower than they were a year earlier. Prices were 0.2% higher than they were in the previous month. With volatile food and energy prices excluded, core inflation over the year in August was 2.8%, which was down a little from 2.9% in July (see Figure 8), but it remains quite high even so. It is of note within this that inflation for services rose to 4.2% in August, which is the highest rate since

4 HCOB Employment Index.

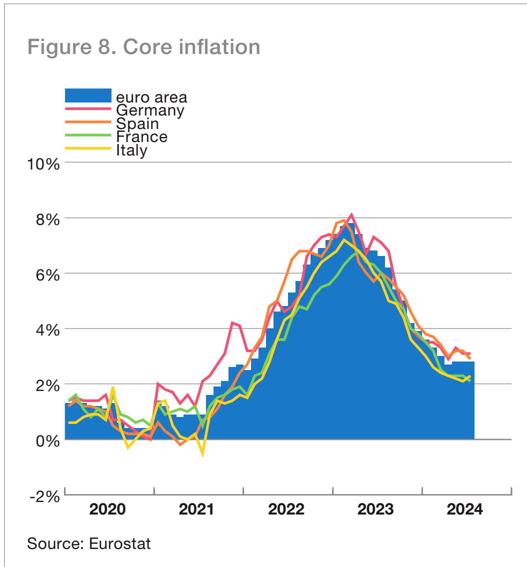


Figure 8. Core inflation

Source: Eurostat

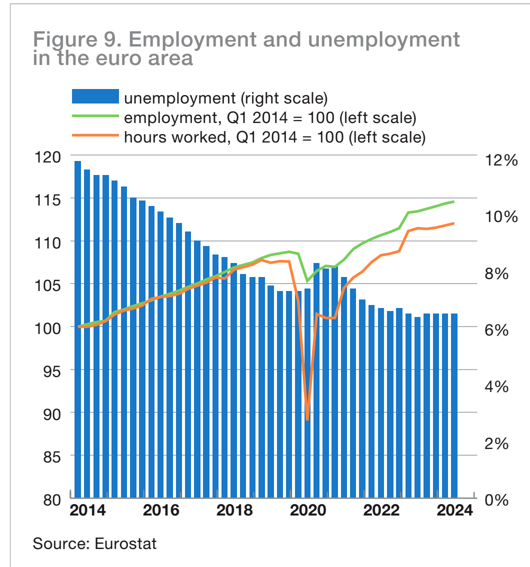


Figure 9. Employment and unemployment in the euro area

Source: Eurostat

last October. Yearly inflation in the larger countries of the euro area was generally around 2%, as it was 1.9% in Germany and France and 2.2% in Spain. Lower energy prices caused inflation in Italy to fall to 1.1% though. The situation in the labour market in the euro area remains good. The unemployment rate fell to a record low of 6.4% in July, and the number of people in employment rose by 0.2% in the second quarter (see Figure 9). Growth in wages as compensation per employee slowed a little in the second quarter to 4.3%, and wage growth from wage agreements slowed to 3.6%. Rising labour costs remain one of the main expenditure problems for businesses.

Box 1: Monetary policy in the euro area

The main objective of the Eurosystem monetary policy is to maintain price stability in the euro area. The European Central Bank defines price stability as annual inflation of 2% over the medium term. Inflation in the euro area has continued to fall in recent months and inflation expectations have come down. The September forecast by the European Central Bank foresees that inflation in the euro area will fall to an average of 2.5% this year, and will then fall to close to 2.2% in 2025 and 1.9% in 2026. The outlook for inflation shows the rate of it moving towards the target of the central bank, and the Governing Council of the European Central Bank decided to ease monetary policy further at its meeting in September.

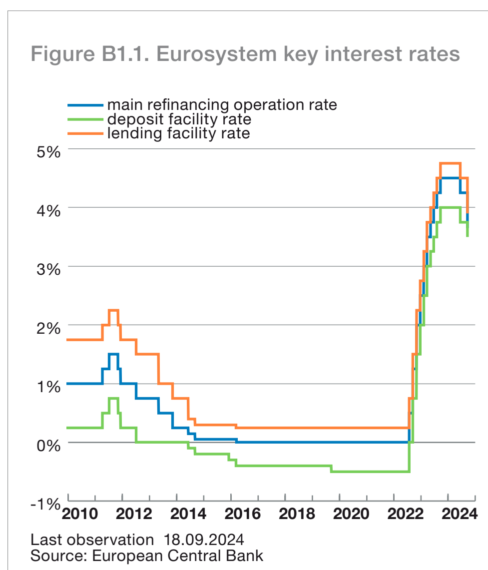


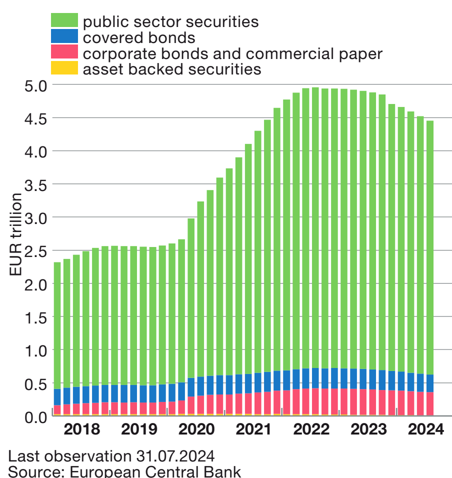
Figure B1.1. Eurosystem key interest rates

Last observation 18.09.2024
Source: European Central Bank

The Governing Council lowered the deposit facility rate by 0.25 percentage point (see Figure B1.1). This is the rate through which it steers the monetary policy stance. The spread between the interest rates was also tightened as the changes announced in spring to the operational framework for implementing monetary policy were made[5]. The spread between the interest rate on the main refinancing operations and the

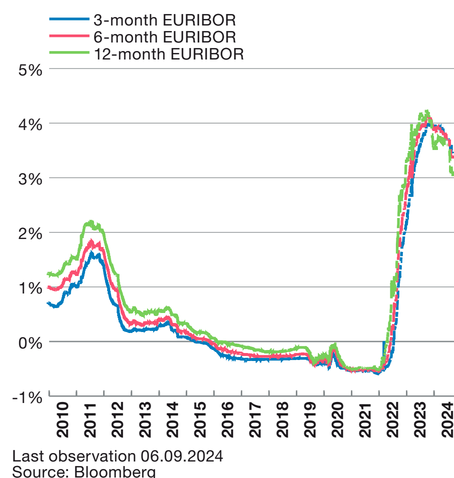
5 On 13 March the Governing Council decided on changes to the operational framework for implementing monetary policy. The framework contains the principles for steering short-term money market interest rates as the Eurosystem balance sheet normalises. The purpose of this is to steer short-term money market rates closely in line with the interest rate on the deposit facility, though some volatility in money market rates can be tolerated as long as it does not blur the signal about the intended monetary policy stance.

Figure B1.2. Eurosystem holdings under the asset purchase programmes (APP and PEPP)



Last observation 31.07.2024
Source: European Central Bank

Figure B1.3. Euro area money market interest rates



Last observation 06.09.2024
Source: Bloomberg

deposit facility rate was reduced from 0.5 percentage point to 0.15 percentage point. The spread between the rate on the marginal lending facility and the rate on the main refinancing operations remains unchanged at 0.25 percentage point. Accordingly the interest rate on the deposit facility is 3.50% from 18 September, the rate on main refinancing operations is 3.65% and the marginal lending rate is 3.90%.

Despite the progress over recent quarters, price pressures in the euro area remain strong as wage growth is elevated. The Governing Council has consequently stressed the importance of the data-dependent approach in its future decisions about interest rates. The Governing Council's policy rate decisions will be determined by its assessment of the inflation outlook in light of the incoming economic and financial data, the dynamics of underlying inflation, and the strength of monetary policy transmission. It has been emphasised that the Governing Council will not make any specific commitments about future interest rate decisions.

The balance sheet of the Eurosystem continues to shrink[6]. Reinvestment of maturing bonds purchased under the asset purchase programme (APP) was discontinued in July 2023 and the Governing Council intends to discontinue reinvestments under the pandemic emergency purchase programme (PEPP)[7] at the end of 2024. From July this year, the volume of reinvestment under the PEPP is being reduced by an average of 7.5 billion euros per month. The total value of bonds purchased under the APP and the PEPP on the balance sheet of the Eurosystem at the end of July was 4.4 trillion euros (see Figure B1.2).

Longer-term interest rates in the interbank market have fallen in consequence of monetary policy being eased, and the six and 12-month Euribors remain below the three-month Euribor (see Figure B1.3). As at 6 September 2024 the 3-month Euribor was at 3.47%, the 6-month Euribor was at 3.35%, and the 12-month Euribor was at 3.03%. The broader M3 indicator of the money supply in the euro area has increased in recent months, and yearly growth in it was 2.3% in July. Yearly growth in loan volumes to non-financial companies increased to 0.6% in July while yearly growth in loans to households rose to close to 0.5%. The European Central Bank considers that the capitalisation and liquidity of the banks in the euro area remains strong.

6 The balance sheet of the Eurosystem has also shrunk because the commercial banks have repaid to the central banks a large part of the longer-term loans that they took. The volume of long-term refinancing operations on the balance sheet of the Eurosystem has fallen since the start of 2022 by around 2 trillion euros to 0.1 trillion euros.

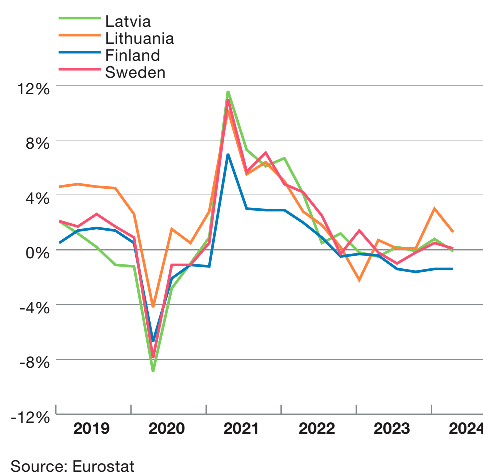
7 Redemptions coming due in the PEPP portfolio are being reinvested flexibly where necessary, to counter the risks from the pandemic to the monetary policy transmission mechanism. This means that more or fewer bonds from one state or one asset class may temporarily be bought in response to market conditions.

TRADING PARTNERS

The return to faster growth has been postponed. The economic climate in Estonia's main trading partners remained weak in the second quarter (See Figure 10). There was a general expectation that the improved purchasing power of consumers would lift domestic demand, but this has not yet happened. Demand for exports in Europe and Asia is also recovering only slowly. GDP in Latvia and Sweden was again smaller in the second quarter than in the previous quarter while exports gave some support to growth in Finland, though they remained at the same level as in the first quarter. The rate of growth in Lithuania was slower in the second quarter than at the start of the year. Lithuania still reported the fastest rate of growth though, at 0.7% over the quarter and 1.3% over the year. The biggest contributors to growth in the second quarter in Lithuania were construction and manufacturing. GDP in Sweden was pushed down hardest in the second quarter by changes in inventory stocks, though this negative impact was offset by growth in exports. The weakness in the industrial sector in Latvia was accompanied by a fall in exports from the services sector, and exports from Lithuania also fell.

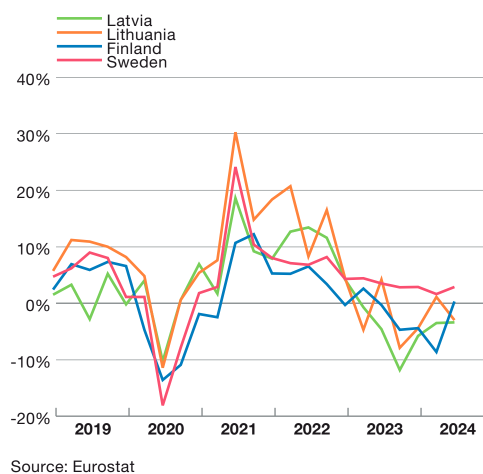
There remains uncertainty about the outlook for exports, and this is restraining the recovery in industry. The optimism of export managers in Sweden[8], where exports have been performing relatively well despite the weakness in target markets (See Figure 11), faded in the third quarter. Industry stagnated over the summer, having recovered rapidly in the spring. The purchasing managers index (PMI) for manufacturing in July was below the 50-point mark. The activity index started to rise again in August, but it was still at a lower level than it was in spring and below its long-term average. Exports from Finland recovered in the second quarter from the hurt caused by strikes at the start of the year, as the volume of exports increased by 8.1% over the quarter, and they were given a boost in June by the delivery of a large cruise ship. Sentiment improved in the industrial sector in Finland[9] in August, but it remains weak in historical comparison. Sentiment in industry in Lithuania also improved, though developments in different sectors varied. Confidence fell in the summer months in the Latvian industrial sector, and exports of goods and services were down by 3.4% in the second quarter.

Figure 10. Yearly growth rates of GDP of trading partners



Source: Eurostat

Figure 11. Yearly export growth of trading partners

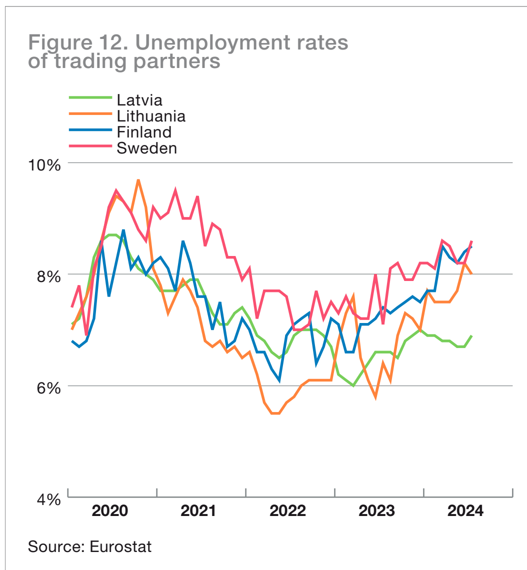


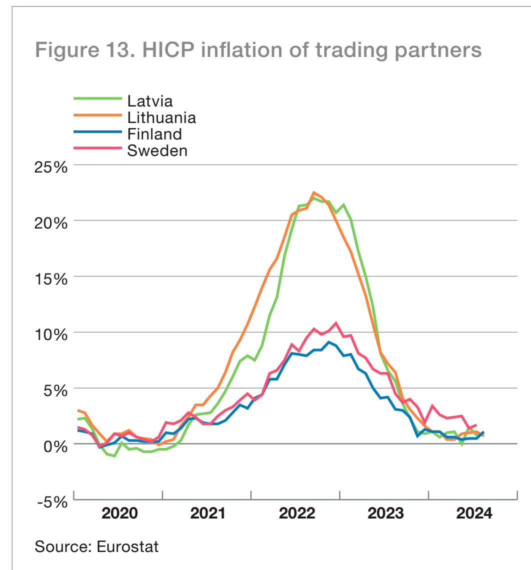
Source: Eurostat

Lower interest rates on loans stirred the real estate markets in Finland and Sweden, where the number of transactions started to rise. There remains a large oversupply, particularly of new residential space, and so the construction sector is not expected to rebound rapidly. This is also shown by the very low level of confidence in the sector. It is apparent though that the construction of new residential space increased over the year in the first half of the year in both Sweden and Finland.

8 Export Manager's Index, EMI, Business Sweden

9 ESI, https://economy-finance.ec.europa.eu/economic-forecast-and-surveys/business-and-consumer-surveys/download-business-and-consumer-survey-data/press-releases_en





Consumers are being cautious about spending. The main expectations for acceleration in economic growth in Estonia's trading partners are built on the improving purchasing power of consumers, which has been backed by lower inflation, falling interest rates on loans, and growth in wages, which has been particularly fast in Latvia and Lithuania. The desire to make purchases has been affected though in Finland and Sweden by the weakness of the labour market (see Figure 12), and in Finland by government policies designed to improve the state finances. The Swedish government in contrast has provided support measures for consumers from the state budget. Consumer confidence has been strongest in Lithuania and Sweden, and is making retail traders more optimistic about the situation. Confidence in retail was weakest in August in Finland, where consumer sentiment has improved, though it still remains much lower than its average over the long term.

Inflation will not fall any further (see Figure 13). Estonia's trading partners had the lowest rates of inflation in the euro area in July. Inflation in Sweden fell below the target level of the central bank, which allowed the bank to cut core interest rates further in August and to indicate that it could cut them up to three more times this year. The downwards influence of energy prices on inflation is weakening, while inflation may be pushed back up by government tax measures, such as the rise in VAT in Finland from September. Large rises in wages in Latvia and Lithuania are holding inflation high in the services sector in particular. Core inflation in July was highest in Latvia at 3.5% and lowest in Finland at 1.5%.

THE ESTONIAN ECONOMY

ECONOMIC ACTIVITY

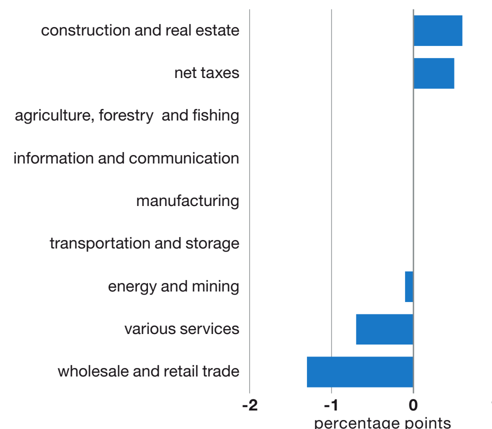
The Estonian economy was no longer deteriorating in the second quarter, but there was equally no general improvement either. Some branches of the economy have been performing better, and expectations of companies about the future have become less pessimistic. Estonian GDP was down 1% over the year in the second quarter, and was at the same level as in the first quarter.

The branches of the economy that affected the decline the most were those focused on the domestic market, like retail and wholesale, and construction. There was some quite unexpected growth in value added in the real estate sector (see Figure 14), which offset the drag on growth in the economy exerted by sectors in decline. As it has habitually done in recent years, the energy sector had a negative effect on growth, though output increased in the largest branches of energy production. Production of both electricity and heat was up by more than 10% over the year in the second quarter of 2024, with the growth in production of electricity coming from renewable sources. Production of solar energy increased by more than a third over the year, and production of wind energy by almost half.

It is hard to draw conclusions about the demand-side sources of economic growth from the statistics available so far. The contributions of both domestic demand and foreign trade to the decline in the economy in the second quarter were larger than the decline in GDP itself, which indicates that a large part of the economic development in the demand components came from the residual, or statistical discrepancy. This suggests that the fall in GDP may have been underestimated, or that there is too little information on the demand components of GDP. The most volatile of those components are change in inventories and investments, though investments still contributed to growth in the economy in the second quarter (see Figure 15).

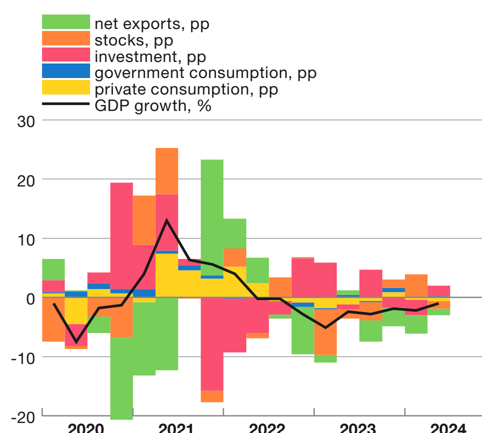
Industrial output has not yet started to grow (see Figure 16). Manufacturing output has remained at around the same level for almost a year and industrial output was actually smaller in June and July than it was on average in the preceding months. Maintenance of machinery and holidays are planned for those summer months, and so it

Figure 14. Contributions to GDP growth by sector in Q2 2024



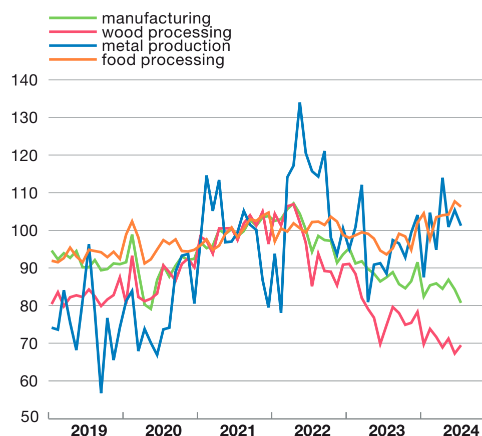
Source: Statistics Estonia

Figure 15. GDP growth



Source: Statistics Estonia

Figure 16. Industrial production volume index of manufacturing, 2021 = 100



Source: Statistics Estonia

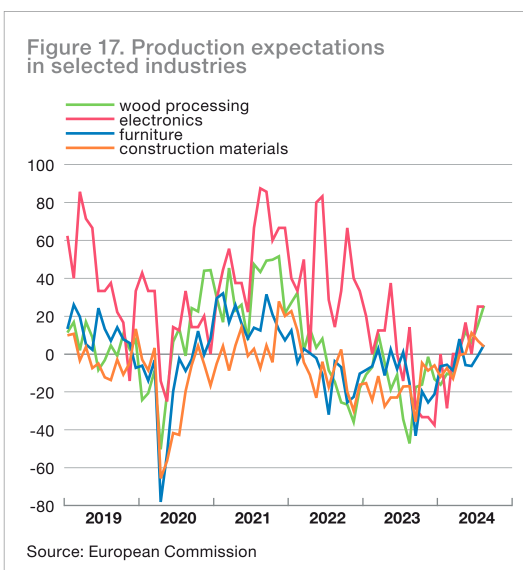
may be that the causes of the decline were only temporary. There are signs in some branches of the economy though of output having increased over the past year.

The expectations of industrial companies for output have become less pessimistic in recent months than they were at the start of 2024 or in summer 2023. Viewed across sectors it is apparent that some branches have ceased to be pessimistic and expect output to increase in the coming months (see Figure 17). This is also shown by the data on industrial output, and so expectations at least show the bottom of the recession to have been passed, and some branches at least expect the economy to recover.

Labour shortages and the level of capacity utilisation indicate that the position of the business cycle in Estonia was a little worse at the start of the third quarter than it was in previous quarters (see Figure 18). This position means that there are resources available in the economy that could be used to increase output if demand improves. The enduring recession in the economy is however probably not entirely cyclical, as potential growth in economy has also slowed.

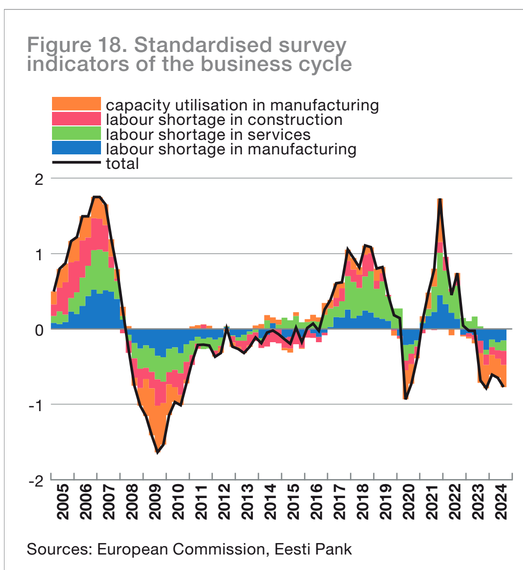
The monthly activity indicators for Estonia's near neighbours at the end of the second quarter and the start of the third quarter showed a slightly lighter tone in the heatmap (see Figure 19). Confidence has also improved a little in construction and manufacturing in Estonia, and the long drawn-out difficulties have not notably raised the unemployment rate. Consumers remain pessimistic though, and people's expectations for

Figure 17. Production expectations in selected industries



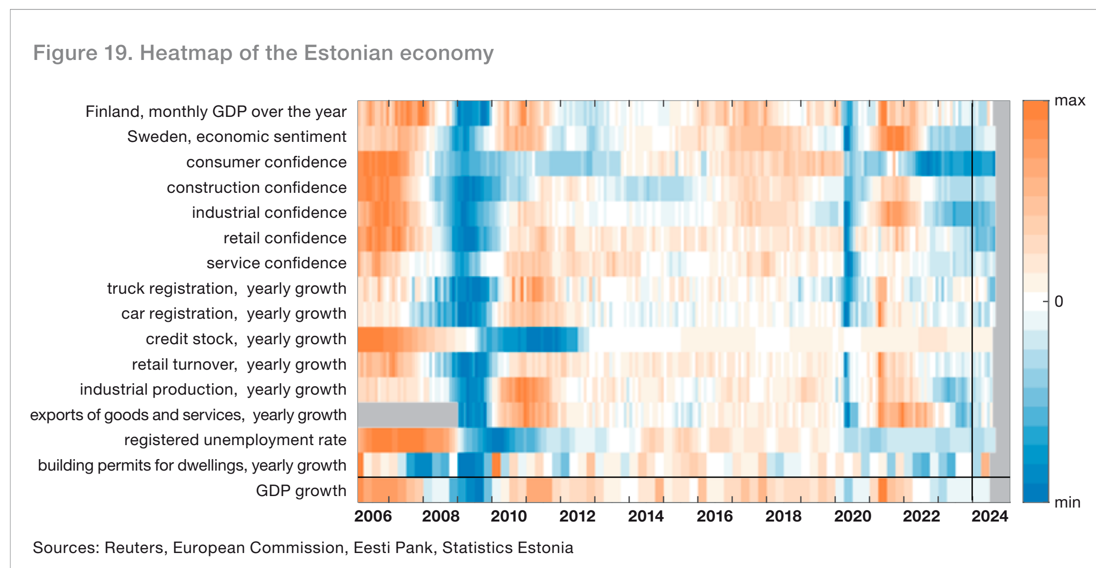
Source: European Commission

Figure 18. Standardised survey indicators of the business cycle



Sources: European Commission, Eesti Pank

Figure 19. Heatmap of the Estonian economy



Sources: Reuters, European Commission, Eesti Pank, Statistics Estonia

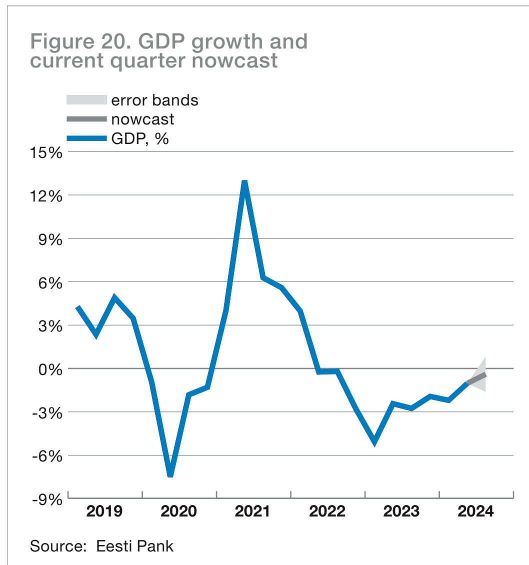


Figure 20. GDP growth and current quarter nowcast

Source: Eesti Pank

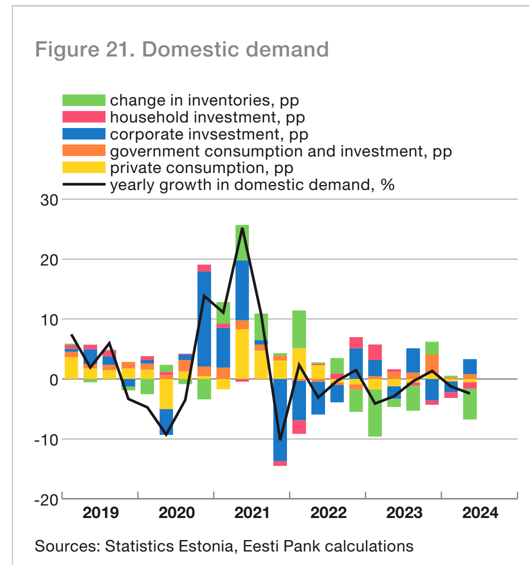


Figure 21. Domestic demand

Sources: Statistics Estonia, Eesti Pank calculations

their own financial position and that of the state deteriorated in August, and there was a fall in interest in making large purchases. Retail companies have also noticed this, and their assessment of current demand is worse than it was during the pandemic, and is approaching the level seen during the great financial crisis. Foreign demand is recovering gradually and is giving some support to the non-financial sector, whose recovery, albeit from a particularly low reference base, is also reflected in the nowcast for the third quarter (see Figure 20).

DOMESTIC DEMAND

Demand in the domestic economy fell in the second quarter because of the weakness in private consumption. Corporate investment grew though despite the low level of confidence (see Figure 21), and general government expenditures and investment were larger than they were a year before (see General government financing).

The cost of borrowing remains higher than before the crisis despite Euribor falling, and financial results were poor in most sectors, but corporate investment has still remained quite strong. The non-financial sector invested 18% more in the second quarter than it did a year earlier. The aggregate figure for growth was given largely by real estate activities and purchases of vehicles for transport. It is hard to see clear evidence of an upwards trend in investment volumes though, as the volatility from quarter to quarter has been unusually large in recent years.

Less new residential space was added to the market than a year earlier, and the interest of households in buying new dwellings remains low. People's purchasing power is increasing gradually, but confidence about the future remains low, while higher interest rates than before and a larger share of income going on essentials means that households have less interest in buying real estate, and are less able to do so. At the same time the amount of residential space receiving usage permits was down by a third, meaning that fewer new developments are reaching the market. Investment in dwellings was a fifth smaller in the second quarter than a year earlier, and the seasonally adjusted level was notably lower than at the start of the year.

Household consumption fell in the second quarter largely because fewer household goods and other durables were bought. Private consumption still remained at the same level as in the first quarter, but it was 1.3% lower than it was in the second quarter of last year. Reluctance to purchase is reflected in the sales revenues of retailers, which have now been falling for more than two years. Retail sales are affected by cross-border shopping and e-commerce, as people are buying and ordering increasing amounts of goods from abroad. Card payments abroad and in foreign online stores grew faster throughout the first half of the year than those in Estonia did (see Figure 22).

Spending on holidays and leisure abroad also increased, while the sales volumes of restaurants and hotels in Estonia declined in the second quarter. Prices have risen by less in the main destinations for travellers from Estonia, and this has made holidays abroad more affordable.

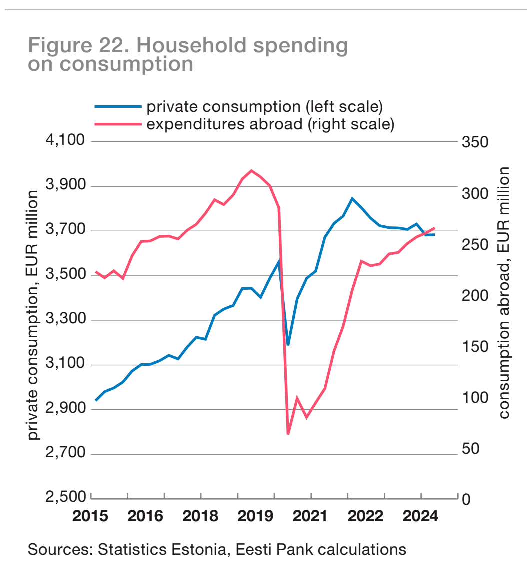


Figure 22. Household spending on consumption

Sources: Statistics Estonia, Eesti Pank calculations

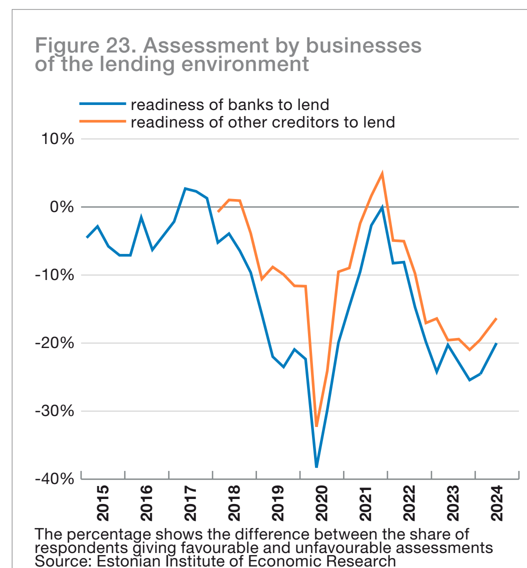


Figure 23. Assessment by businesses of the lending environment

The percentage shows the difference between the share of respondents giving favourable and unfavourable assessments
Source: Estonian Institute of Economic Research

The growth in foreign travel and spending abroad is also confirmed by the number of air passengers exceeding the level of 2019. Spending abroad remains however at 6% of private consumption, where it was around 9% in 2019.

While activity in the economy has been weak, borrowing activity has remained strong. Yearly growth in the portfolios of loans to companies and households was a little over 6% at the end of July, and the growth in the corporate loan portfolio has been accelerating gently in recent months. Long-term loans to companies in energy, real estate and retail have driven the growth, while the portfolio of loans to the industrial sector has grown a little in monthly terms since the spring. The value of new housing loans has been around 20% larger in recent months than it was a year ago, mainly because of campaigns at the banks aiming to tempt clients away from competitors. The consequence has been more refinancing of loans from other banks than before. Financing has become easier for the banks as both household and corporate deposits have started to grow again, and once again only a third of deposits at most are term deposits. This means that deposits as a funding source are again relatively cheap for the banks. Loan interest rates have come down in the past half year as Euribor has fallen, and the average margin has remained around where it was at the start of the year.

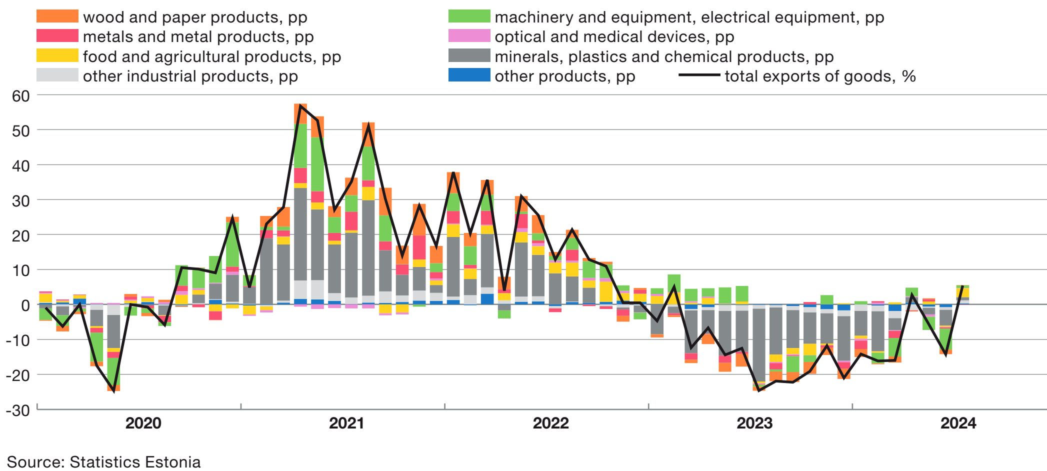
Inventories shrank in the second quarter of the year. Above all there was a substantial drop in goods purchased for sale at companies selling motor vehicles. This shows that car dealers consider they have sufficient stocks and have not moved to increase them in advance of the introduction of the car tax. Stocks of finished products increased substantially in manufacturing, especially wood processing, which could indicate difficulties in selling products. However stocks of raw materials and inputs increased by the same amount in wood processing, confirming the improved confidence about new orders of businesses in the second and third quarters.

EXTERNAL BALANCE AND COMPETITIVENESS

Foreign demand recovered gently in the first half of 2024, but did so at a slow rate that varied across countries. As demand recovers, so Estonia's exports of goods are emerging from their long slump, and the volume of exports increased over the quarter in the second quarter for the second consecutive quarter. Volumes of exports and imports were still a little lower in the second quarter than they were a year previously though, as exports of goods and services were 1.7% down on a year earlier, while imports were down 0.3%.

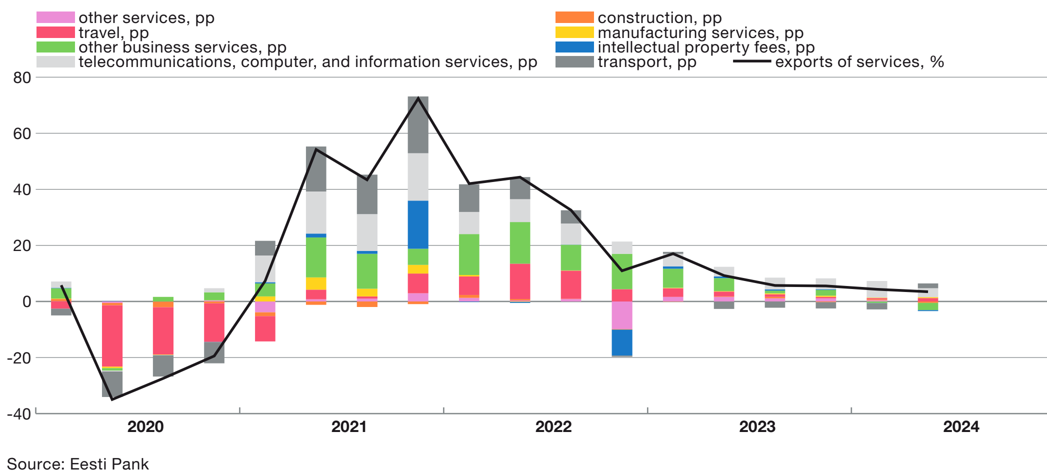
Exports of goods have been supported by the improvement in demand, but the turnover of exports was volatile at the start of summer. There was an increase in exports of goods at the start of the second quarter, but the turnover fell again in May and June (see Figure 24). This volatility within the quarter indicates that manufacturing is still in quite a precarious position, but the three months taken together show that the enduring difficulties are by now in the past. The better

Figure 24. Exports of goods and contributions of groups of goods



Source: Statistics Estonia

Figure 25. Exports of services and contributions of groups of services

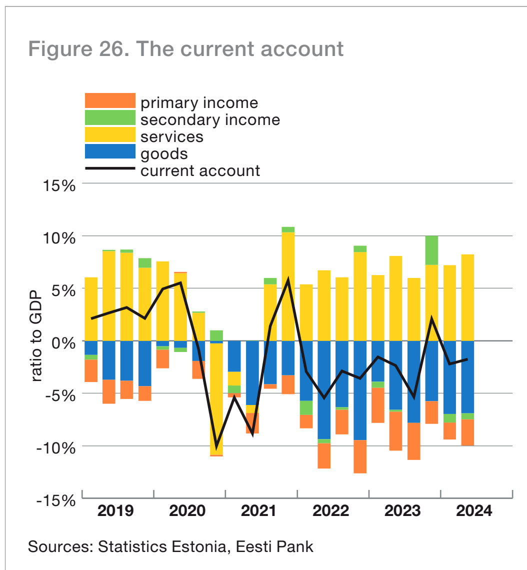


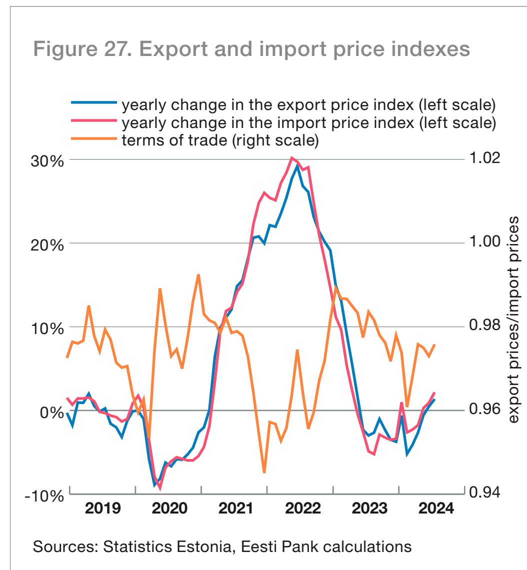
Source: Eesti Pank

performance than before of exports is also indicated by the turnover of exports in the most important sectors starting to grow, though there was a setback in June in exports of wood products and of machinery and equipment. The difficulty for wood products was largely due to seasonal factors, but there may be different reasons why exports of machinery and equipment fell, such as seasonal factors as the holiday season started, the continuing decline in exports to Russia, and the slow speed of recovery in demand from trading partners. It appeared at the start of the year that growth was recovering in Germany, but the message from there more recently has not been as positive. Things have perked up in Scandinavia, particularly strongly in Sweden, and also a little in Finland.

The sluggish performance of the economy in general is also reflected by imports of goods and services, as the volume of imports was about the same in the second quarter as it was a year earlier and in the previous quarter. Goods imports were affected substantially by the situation in manufacturing and the need for inputs there. The decline in the turnover of imports of machinery and equipment played a major part in total imports, while the continuing decline in imports of fuels has not entirely ceased. The volume of imports of services has remained relatively constant for four consecutive quarters now, with growth close to zero.

The turnover of exports of services continues to grow steadily. If inflation is discluded though, the exports of services in the second quarter were only 0.8% larger than those a year earlier, and the volume was even down slightly on the previous quarter. Demand was particularly good for

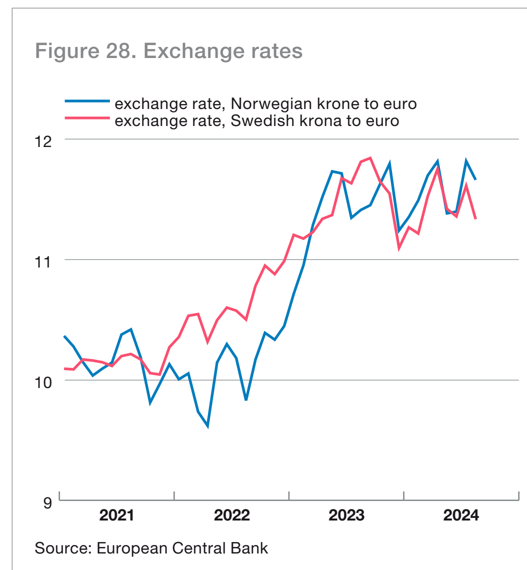


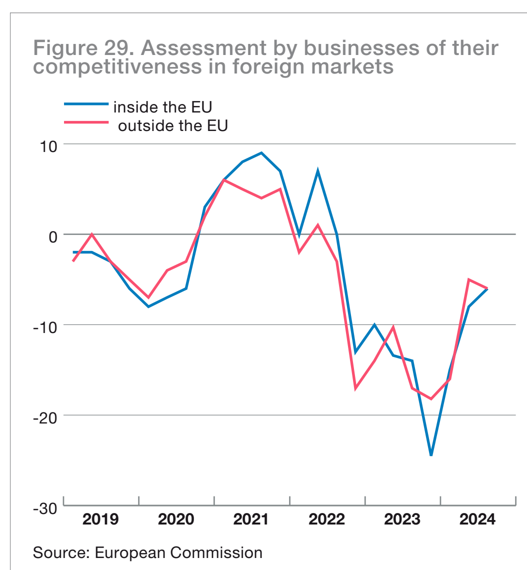


information and communications technology, which is one of the largest groups of services, as exports of ICT services were up by 14% in the second quarter. The turnover of exports of travel services increased by 9%, while exports of transport services grew for the first time in a long time, gaining 8%. Exports of other business services were down by 8%, which affected total turnover as they provide around 30% of total exports of services (see Figure 25).

The current account was in deficit by 170.2 million euros in the second quarter of 2024, which was 1.7% of GDP. The current account continued to receive support from the surplus on the services account, which was larger than in the first quarter of the year (see Figure 26). The balance for services was positive by 8.2% of GDP, while the balance for goods was negative by 6.9% of GDP.

Terms of trade have improved on aggregate across sectors, but the growth in import prices in manufacturing was a little faster than the growth in export prices, and the terms of trade worsened over the summer. Prices for exports and imports have been rising a little since the start of the year (see Figure 27). The growth in the cost of production inputs varied across segments within manufacturing during the summer, as prices for imports rose fastest in metal processing and food processing for example. Prices rose sharply in July in wood processing as well, but import prices in furniture production fell throughout the first half of the year. The currencies of Sweden and Norway have stopped depreciating, and trade remained favourable for Estonia in the first half of the year (see Figure 28). Recovering demand has also supported Estonian exports to Scandinavia.





Some improvement was seen in the first half of the year in the estimates by businesses of their export orders and their competitiveness. The more optimistic stance was more in evidence at the start of the year, but was maintained through the second quarter (see Figure 29).

THE LABOUR MARKET

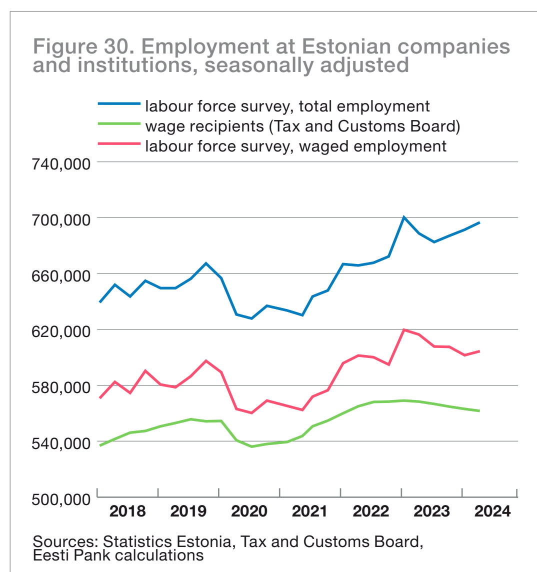
There were no significant changes in the labour market in the second half of 2024. Unemployment and the seasonally adjusted number of waged workers were approximately unchanged from the start of the year, though survey data showed that the number of people engaged in enterprise increased. Most of the labour market indicators show that the recession bottoming out has been accompanied by the negative trends in the labour market turning, so that the number of job vacancies advertised is no longer falling for example, while the expectations of companies have stabilised.

The labour force survey shows that employment in Estonian companies and institutions increased in the second quarter, though this was because of a rise in the number of people engaging in enterprise, or working for themselves. The number of workers receiving a wage was at the same time lower than a year earlier because of the weakness in the economic climate (see Figure 30). The fall in the number of waged employees is in line with what register data show as well. The labour force survey shows there were 1.9% fewer people receiving a wage at Estonian companies and institutions than a year earlier, while there were 1.1% fewer declared recipients of wages and 1.4% fewer employment relationships in the employment register. The picture was better than it was at the start of the year though, because the decline in the seasonally adjusted number of wage recipients had slowed, there were more employment relationships than in the first quarter, and the number of wage recipients was a little higher than it was at the start of the year even in the labour force survey.

Register data show that the largest falls in the number of wage recipients in the second quarter of 2024 were in construction and real estate; manufacturing and closely linked activities; administrative and auxiliary activities, which also covers temporary work; and transportation and storage. The number of wage recipients also fell in some branches of the services sector such as retail and professional, scientific and technical activities (see Figure 31). Branches of the public sector that saw employment continue to increase were education and healthcare, while the growth in employment in public administration slowed. The employment register shows a fall in the first half of 2024 in the number of contracts for civil servants and higher state officials.

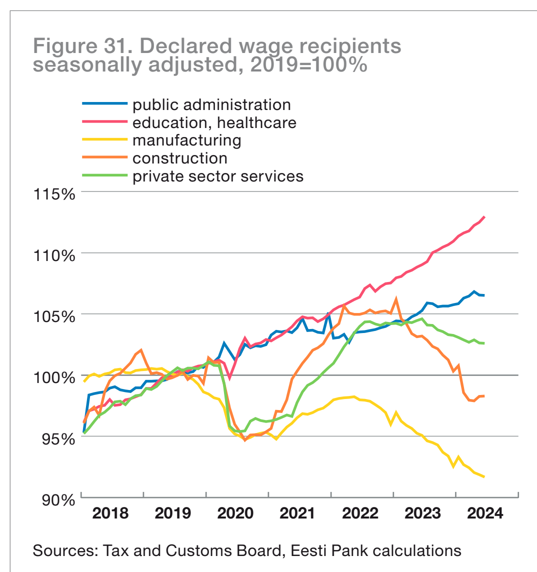
Labour force participation increased further in the first half of 2024 and reached a new record of 75.4% in the second quarter. The number of people out of the labour market because of retirement, health problems and caring for family members fell further, while the number of people who had given up looking for a job because

Figure 30. Employment at Estonian companies and institutions, seasonally adjusted



Sources: Statistics Estonia, Tax and Customs Board, Eesti Pank calculations

Figure 31. Declared wage recipients seasonally adjusted, 2019=100%



Sources: Tax and Customs Board, Eesti Pank calculations

they had lost hope of finding one increased. The number of people under temporary protection has fallen throughout 2024, as there are fewer new people arriving under it than there are people exiting it, or who have not updated their status.

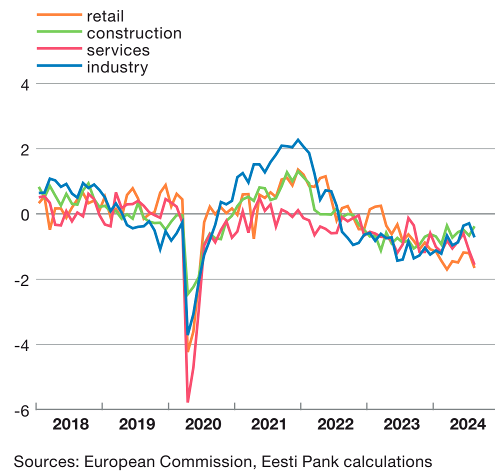
The expectations of companies for further development in employment were below their historical average in the first half of 2024 (see Figure 32). Some improvement has been apparent in manufacturing and construction since the second half of 2023 despite the volatility from month to month. The number of jobs intermediated by Töötukassa hit a low point in autumn 2023, and after a small rise it has since remained largely unchanged.

The unemployment rate reached 7.6% in the second quarter of 2024, which is a little lower than where it was in the previous quarter (see Figure 33). Unemployment is probably affected to some degree by the fall in unemployment among refugees from the war in Ukraine. The rise in unemployment has been limited in some sectors like construction by people who have lost a job starting to work for themselves. Registered unemployment fell a little in the second quarter, but this was partly because the number of refugees from the war in Ukraine registered with Töötukassa was smaller. The number of people registered as unemployed who were under temporary protection fell, while the number of local residents registered rose a little. It was notable that there was a rise in the number of people with a background in IT who were registered as unemployed.

The labour shortages felt by employers remained below their historical average level, and so there was no indication yet of increased demand for labour (see Figure 34). The indicator for labour shortages in manufacturing and services has remained essentially unchanged since the start of 2024, and has not fallen any further.

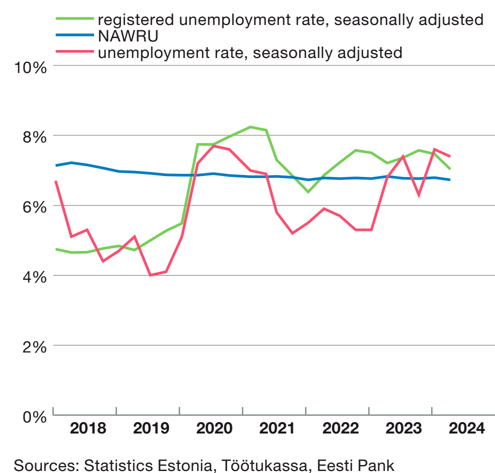
Growth in the average wage slowed to 7.2% in the second quarter of 2024 from 8.8% in the first quarter, and this growth put it above the 2000-euro mark for the first time at 2007 euros. Real wages were 4.3% higher than a year previously, and falling inflation meant that this rate of growth was as fast as it was in the first quarter (see Figure 35). Wages are still growing faster in the public sector than in the private sector, but the growth slowed most in local government administration.

Figure 32. Employment expectations, standardised



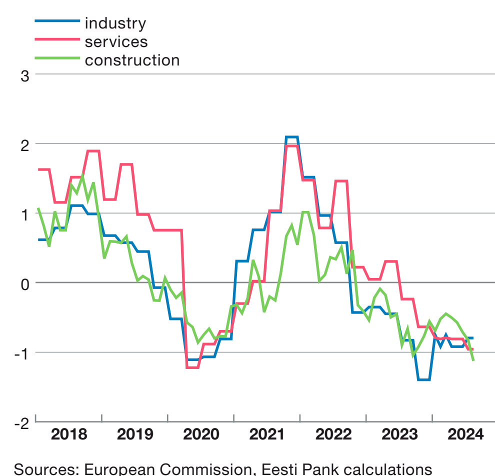
Sources: European Commission, Eesti Pank calculations

Figure 33. Unemployment



Sources: Statistics Estonia, Töötukassa, Eesti Pank

Figure 34. Labour shortages, standardised



Sources: European Commission, Eesti Pank calculations

Wages rose faster in the services sector, where the rise in the minimum wage had a larger impact, and they rose more slowly in manufacturing and construction, where demand for labour has dropped the most because of the recession.

The national accounts show that the growth in the payroll of the entire economy in the second quarter of 2024 was 4.5%, having been 5.2% in the first quarter. At the same time the employer share of value added, which is costs and profits, fell by 1.5% over the year, while unit labour costs increased (see Figure 36). It is not unusual for the labour share of value added to increase during a recession, as employees are kept on the payroll to allow production to be restored faster when demand for output starts to increase again. Once the crisis is over, the situation reverses as profits start to recover first.

PRICES

The yearly growth in consumer prices started to accelerate again in the third quarter. Inflation was down to 3.4% in July, but rates of inflation were different for goods and for services. Inflation for food and manufactured goods remained at close to 2%, but for services it increased to 7.6%. Differences in inflation rates within core inflation are described in more detail in Box 2.

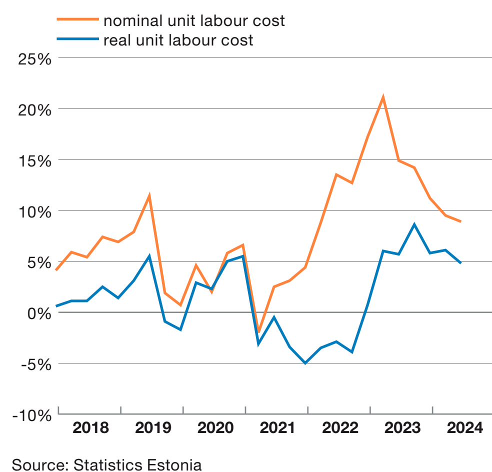
It was mainly prices for services that rose in the first half of the year. This was also partly because of growth in wages of close to 7% (see Figure 37). A rise of 4% in rents in July as activity increased in the real estate market had a notable impact. The largest rise in administered prices was of 20% in the price of water and sewage services, while the increase in state fees also had some impact. Inflation was high in the private sector for accommodation services and package holidays as July is the tourist season, and seasonal inflation in the tourism sector remained high in July.

Inflation for goods has been restrained by prices for raw materials being lower than they were and by shops adding smaller markups. Prices of clothing and footwear fell over the year in July for the first time since 2021, partly because of sales. Demand is weak and reduced retail sales volumes mean it is not easy to raise prices, and in any case clothing and footwear is already more expensive in Estonia than it is on average in the other countries of the euro area.

Figure 35. Yearly change in average wages*

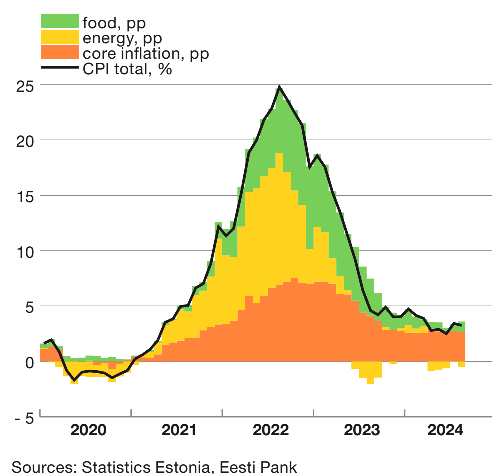
* Structural break in 2022; series for 2019-2021 adjusted by Eesti Pank
Sources: Statistics Estonia, Eesti Pank

Figure 36. Growth in unit labour cost



Source: Statistics Estonia

Figure 37. CPI growth

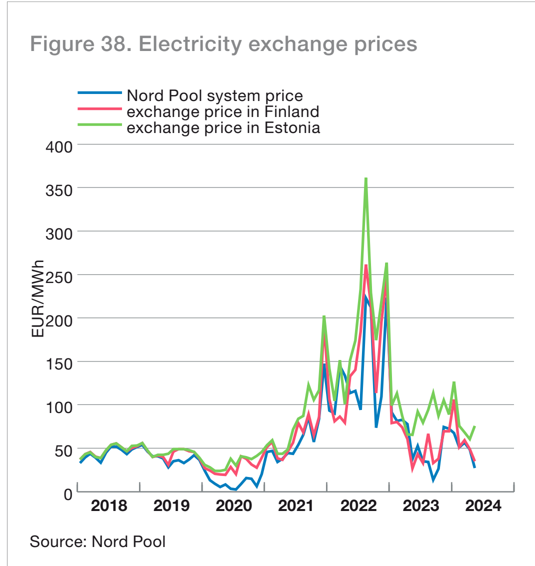


Sources: Statistics Estonia, Eesti Pank

Prices for production inputs have already started to climb. Import prices rose to be higher than they were a year earlier in May, export prices joined them in June, and producer prices did so in July. The import prices that have risen the fastest have been those for agricultural commodities and food. Inflation in manufacturing has been driven by higher prices for machinery and electronics, while the earlier sharp fall in prices of construction materials has come to an end.

The price of energy in July was about the same as it was a year earlier. The exchange price for electricity has risen steadily in the Baltic states in recent months, and it has approached 100 euros per megawatt hour (see Figure 38). Electricity costs only around 20 euros per megawatt hour in Finland and Sweden, but the interruption to the Estlink 2 cable means that the cheap electricity has not reached consumers in Estonia. Regular maintenance work at power stations also affected the price of electricity. Gas was 29% more expensive in July than it was a year earlier, partly because of a rise in network fees. The oil price fell however to 80 dollars a barrel, and prices for motor fuels also fell because oil refiners reduced their markups.

Figure 38. Electricity exchange prices



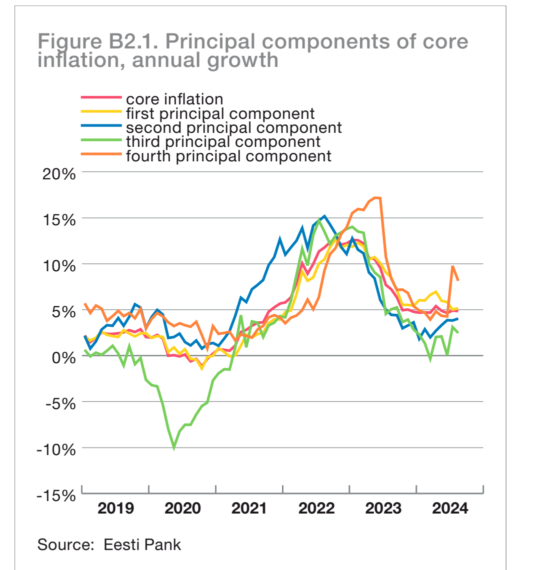
Source: Nord Pool

Box 2: Differences in inflation rates across the components of core inflation

Core inflation, having risen at a record rate last year, has come back down this year. The rates of increase in the prices of the different goods and services that are covered by core inflation were however very different. Inflation for manufactured goods has slowed, but inflation for services remains high in historical comparison. This box considers the factors that have caused such large differences.

The multiple crises coming one after another have affected the components of core inflation differently. Prices with similar developments can be extracted using principal component analysis, and then similar prices can be grouped. Figure B2.1 shows the first four principal components of core inflation, which explain the largest part of the variation in core inflation[10]. It can be seen that the rates of change in the components of core inflation started to diverge even before the Covid-19 pandemic.

Figure B2.1. Principal components of core inflation, annual growth



Source: Eesti Pank

The largest part of the rise in prices can be linked to increasing wage costs for companies. Growth in wages accelerated to close to 10% in the first quarter of 2022, and at the same time inflation jumped up for many goods and services. This is reflected in the first principal component of core inflation, which as a share of the consumer basket covers 60% of core inflation. This covers items

10 Hamilton, J. D., and Xi, J. (2022), Principal Component Analysis for Nonstationary Series, Working Paper, UC San Diego.

like holiday travel, and also clothing and footwear, where the markups of merchants are a large part of the price. The inflation that is dependent on wages has started to come down recently.

The second principal component of core inflation is goods that started to rise rapidly in price at the start of the pandemic. Supply problems pushed up the prices of household electronics, and raised the prices of cars. Demand-side price pressures made construction materials more expensive, as a lot of people looked to renovate their homes. Inflation of imported goods has exited its deceleration in recent months, and prices have started to rise again.

The prices of distinct services started to fall at the start of the pandemic in contrast, and this is reflected in the third principal component of core inflation. Accommodation prices fell in Estonia in summer 2020 by more than a quarter for example, which was one of the steepest falls in the euro area. Government measures to ease the impact of the pandemic caused prices to fall even further as free public transport and school lunches were introduced. There was also a cut in prices for water and wastewater services in Tallinn at the same time. Accommodation prices rose after the pandemic faded, but the rise in them has slowed again this year.

Administered prices started to rise later than those for other services, and those prices remain an exception from other prices. Administered prices are the fourth principal component of core inflation and include prices for medical services, social care and education. The costs of social care often move together with pensions, which themselves depend on changes in the consumer price index with a lag.

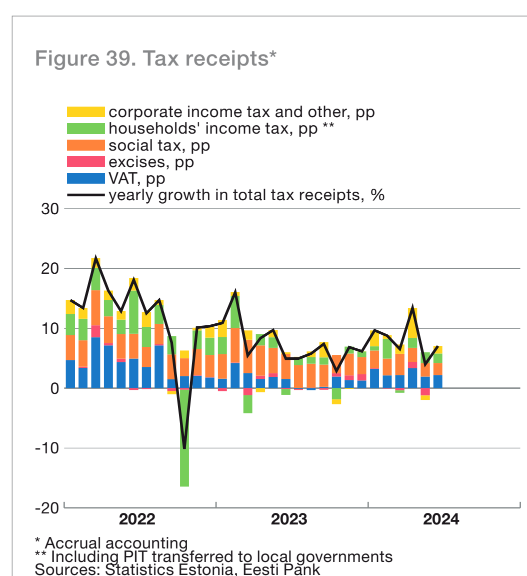
The principal component analysis of core inflation indicates that the price pressures in the Estonian economy coming from wages have started to ease. Inflation will still be held up by the tax rises that were introduced at the start of the year. The rise in administered prices is highly dependent on the high inflation of last year because of indexing.

GENERAL GOVERNMENT FINANCING

Tax receipts in the second quarter mirrored the weakness in private consumption and slowing growth in wages. The state received 9.1% more in VAT than it did a year earlier, but this was only because the VAT rates were a tenth higher than they were a year before. This meant that the growth in VAT receipts was actually smaller than the rise in the VAT rate itself, which is in line with a decline in private consumption and with the economy being smaller than it was a year before. Receipts of alcohol excise were 11.1% less than they were in the second quarter of last year despite the alcohol excise rate having risen by 5%. Receipts of fuel excise were however 10.9% higher than a year previously, and that growth was driven by a rise in the rate of diesel excise from 1 May.

A fall in the number of people earning a wage and slower growth in wages restrained the receipts of labour taxes in the second quarter. Yearly growth in social tax receipts slowed from 7.3% in the first quarter to 5.5% in the second. Receipts of personal income tax were up 8.9% over the year, while corporate income tax receipts were up 28.5%. Receipts of corporate income tax supported tax revenues throughout the whole of the first half of the year. Dividends are paid out in the first half of the year, and a lot more profit was distributed as dividends this year than last year. Tax revenues in total were 8.0% higher in the second quarter than in the same quarter of last year (see Figure 39).

Figure 39. Tax receipts*



* Accrual accounting
** Including PIT transferred to local governments
Sources: Statistics Estonia, Eesti Pank

Investment in construction led the growth in general government expenditures on investment in the second quarter. Investment in buildings and structures was 17.6% higher in the second quarter than it was a year previously. Investment in various machinery and equipment was also up by more than a tenth, and that growth was driven by investment in telecommunications equipment and other machinery and defence assets. Strong growth also continued in investment in research and development activities. Investment by the general government was in total 13.5% larger than at the same time in the previous year. Accounting data from general government entities show investment was larger than in the second quarter of last year by most in national defence and the economy, and it was smaller in healthcare.

Spending by the general government on final consumption was up by 7.1% over the year in the second quarter. This increase was slightly smaller than that in the first quarter. Growth is most clearly slower in the general government payroll, as data from Statistics Estonia show yearly growth in it slowing from 11.4% in the first quarter to 9.4% in the second. More than half of general government employees work in healthcare and education, and data from Statistics Estonia show that wages there continued to rise faster than the average in Estonia in the second quarter, increasing by 11.3% in healthcare and 8.4% in education. The growth in wages in public administration was one of the slowest across all sectors at only 5.2%. The data from Statistics Estonia also show the number of people working in public administration fell by 2%, which also helped slow the growth in the payroll. Growth in general government spending on intermediate consumption increased, and those expenditures were around a tenth higher than they were in the second quarter of last year. The growth in social benefits continued to slow notably in the second quarter. Pensions increased by less on 1 April this year than they did a year earlier because the effect of indexing was smaller, while 13.3% less was paid in child and family support in the second quarter of this year than a year earlier.

THE EESTI PANK ECONOMIC FORECAST FOR 2024-2026

The Eesti Pank economic forecast is produced jointly by experts from the central bank's Economics and Research Department and Financial Stability Department. This forecast takes account of new information received since the forecast published in June on the economies of Estonia and other countries. The forecast is shaped by revisions to published data and statistics, and also by updated assumptions about the exchange rate, the financial sector, commodities and export markets, and the state budget, and these are shown below. The Eesti Pank forecasts are compiled and correspondence between the economic indicators is ensured using EMMA, the macro-model of the Estonian economy developed and constantly updated by Eesti Pank. The model forecast is produced by extending economic relations and processes that have already been defined into the future, with economists from the central bank making adjustments such as structural changes or expected temporary deviations where necessary.

The forecast this time contains two scenarios, with a baseline forecast that takes account of the fiscal policy that has currently been enacted, and an additional scenario that considers the measures planned by the government for improving the fiscal position[11]. The additional scenario uses the description in the chapter on changes to the state finances of the coalition agreement signed on 22 July. This is a preliminary economic impact assessment, as the volume of the measures and the full details of their content will only be made clear in the state budget 2025, and in the state budget strategy for the next four years. The government is also considering new measures at the same time that were not in the coalition agreement, and that could change the outlook even further if they come to pass.

THE INTERNATIONAL ECONOMIC ENVIRONMENT

The global economy

The global economy will continue to grow, but uncertainty about the future has increased. The International Monetary Fund (IMF) forecasts that growth in the global economy in 2024 will be 3.2%, and that it will be 3.3% next year[12]. This will be driven by rapid economic growth in the Asia region, primarily India and China. Growth in advanced economies will be slower, as the fiscal policy support there will be reduced. Growth in the US economy will be hampered in 2025 by the labour market cooling and by consumption consequently doing the same. Growth will be modest in the economies of the United Kingdom, the euro area and Japan this year, though it will pick up a little next year. Growth in the Chinese economy will be restrained by the slump in the real estate sector, weak consumer confidence, and worsening economic relations with Western countries, and so it is expected to slow a little. Various factors overshadow the outlook for the global economy. The continued decline in economic activity in manufacturing globally may impede growth in the global economy in future. Increasing geopolitical tensions could cause uncertainty and affect commodities prices. The presidential elections in the United States in November will cause uncertainty about further growth in global trade and the global economy, as they may result in trade barriers and higher tariffs.

Inflation will continue to slow. Inflation will fall, but at a slower rate than it has been doing, as energy and food prices have already returned to their levels from before the pandemic. The IMF forecasts that inflation will reach the target of 2% set for it by the central banks of advanced economies by the end of 2025. The rate of inflation has come down in the euro area and the United Kingdom, and this trend will continue. This will allow central banks to continue cutting base interest rates. Inflation for services and growth in wages remain high in the USA, and so the Federal reserve started cutting its base interest rates later than other central banks. Wages continue to rise relatively fast in advanced economies, which will push central banks to keep base interest rates at a relatively higher level for some time yet than they were at before they started rising.

The euro area

The outlook for economic growth in the euro area will improve over time. There remain concerns over trends in Germany, the largest economy in the euro area, as the industrial sector there

11 Under the forecasting rules of the European System of Central Banks, the central banks of the euro area only take account in their baseline forecasts of political changes that have already been passed into law and that are certain to be implemented. All other alternative outlooks are presented in additional scenarios.

12 IMF World Economic Outlook, July 2024.

continues to struggle. Germany's energy-intensive industrial sector, particularly car-making, has not managed to adapt quickly enough to new technologies and climate demands, and this will hurt the competitiveness of the country. Furthermore, growth in the Chinese economy and demand have not accelerated at the rate that was hoped for despite some increase, and this will impact the German industrial sector and that of the whole euro area. Demand for output from the euro area will still improve in the longer term as economic growth recovers. The improvement in economic activity in the euro area will largely be supported by growth in the services sector. Businesses will build up inventories for the autumn and winter holiday period, as they remain worried about their security of supply given the problems in the Red Sea and the consequent rise in the prices of maritime transport. Looser monetary policy will still support the financial position of Estonian companies in the near term though, and will encourage investment. Geopolitical problems around the globe and international trade conflicts will endure however, and they may cause shortages of commodities and higher prices in supply chains, which will cast a shadow over the outlook for economic growth in the euro area and in the rest of the world. The Eurosystem forecasts that the growth in the euro area economy this year will still be modest at 0.8%, but it will increase next year to 1.3% and then to 1.5% in 2026.

Inflation will fall in the euro area, but prices for services will initially continue to rise fast. Inflation will continue to fall and the purchasing power of consumers will recover in the euro area, but wage growth remaining fast will push up the prices of services quickly. This will make consumers cautious in their purchasing behaviour. As services are generally labour-intensive, the rising prices in the service sector will probably be reflected in tensions in the euro area labour market, where there are still labour shortages in some sectors and it is not easy to reduce staff numbers even when times are difficult. Growth in profits will help companies to survive the rapid rise in labour costs. There has been some sign of wages rising more slowly in the euro area, which suggests that the peak of wage growth may have been passed. Inflation in the euro area can consequently be expected to fall by the end of the forecast horizon in 2026 to 1.9%.

Estonia's main trading partners

The economic climate in Estonia's main trading partners will barely improve. This is because the recovery in demand in the export markets of those trading partners, most notably the euro area, has been delayed. Growth in the real incomes of domestic consumers and gradually improving confidence have not yet been reflected in notable growth in consumption. The economies are expected to grow faster from the second half of the year or from next year, when loan interest rates will have become less constricting. Lower interest rates mean that the real estate market is expected to revive. There is currently still excessive supply in Finland and Sweden, which is hindering any recovery in the construction sector. The recovery in the Swedish economy will be supported by interest rate cuts from the central bank and also by fiscal stimulus from the government, while Finland will raise taxes and cut spending to stop its debt burden growing.

TECHNICAL ASSUMPTIONS USED IN THE FORECAST

Assumptions for the external economy

Several assumptions for the external economy have moved in directions that favour Estonia. The expectations for interest rates found from future transactions in the money markets are a little lower than they were in the June forecast, and so may be expected to have a beneficial effect on the economy. The three-month Euribor should average below 2.5% over the next year and approach 2.2% in 2026. Markets expect that gas prices will this year be close to 34 euros per megawatt-hour, and will then see some temporary rise. The change from the June forecast in expectations for the exchange rate between the euro and US dollar is quite small and has little effect on the forecast. Growth in the main markets for Estonia's exports of 0.6% this year is a little weaker than was earlier expected, but in the next two years it is forecast to be similar to what was earlier thought, at just over 3%. The expected changes in price for industrial commodities and food commodities have been adjusted downwards, which means that the cost pressures will be lower for producers in Estonia and in the other countries of the euro area (see Table 2).

Table 2. External assumptions in the forecast [1)]

	2023	2024	2025	2026	June 2024 projection 2024	2025	2026
Foreign demand growth (%) [2)]	-1.3	0.6	3.2	3.2	1.0	3.2	3.1
Export price growth of competitors (%) [3)]	-5.2	0.3	2.1	2.3	0.8	2.5	2.3
USD/EUR exchange rate	1.081	1.087	1.095	1.095	1.079	1.077	1.077
Interest rate (three-month EURIBOR, %)	3.4	3.6	2.5	2.2	3.6	2.8	2.5
Oil price (USD/barrel)	83.7	83.2	76.1	73.2	83.8	78.0	74.5
Natural gas price (EUR/MWh)	40.6	34.2	41.1	35.6	30.8	35.4	29.9
Price growth for industrial commodities (USD, %)	-14.4	3.2	5.0	5.2	5.7	6.4	3.1
Price growth for food commodities (EUR, %) [4)]	-2.1	-3.5	-2.6	0.2	-1.2	0.8	-0.3

1) Cut off date of technical assumptions is 16 August 2024, apart from foreign demand, which has the cut off date of 29 August
2) Weighted growth of imports of trading partners 3) Weighted growth of exports deflator of trading partners 4) Food commodity price index of the European Commission Directorate-General for Agriculture and Rural Development (DG AGRI)
Source: European Central Bank

Assumptions for general government financing

The baseline forecast takes account of the tax changes that have been passed. VAT rose on 1 January 2024 from 20% to 22%, while alcohol excise rose by 5% from 1 January and excise rates on various tobacco products also rose by an average of 5%. Excise rates on various fuels and electricity rose from 1 May 2024. Rises in the coming years in various fuel, electricity, alcohol and tobacco excise rates have been legislated, together with changes to personal and corporate income tax systems that will apply from 1 January 2025. The September forecast also takes account of the motor vehicle tax that was passed in the summer. The motor vehicle tax that will start to apply from 1 January 2025 is expected to increase tax revenues by about 230 million euros a year. The additional scenario considers other possible changes to the tax system.

A large part of the forecast for general government spending comes from the summer forecast of the Ministry of Finance. The outlook for general government investment, intermediate consumption spending and the payroll is based on information from the summer forecast of the Ministry of Finance (see Table 3). The forecast for 2024 for the general government payroll has been adjusted using statistics that have already been disseminated.

ECONOMIC GROWTH

Several factors that have been an obstacle to economic development are disappearing or have disappeared. Growth in the Estonian economy has so far been held down by high interest rates, weakness in foreign markets, and the high cost of energy. High interest rates have bitten into domestic demand and reduced demand for Estonian goods in foreign markets, and have particularly reduced demand for investment products, so a fall in the cost of money should ease matters. Energy prices have not fallen back to the levels that they were at before Russia launched its full-scale invasion of Ukraine, but they have come down some way from their peaks and this has helped make Estonian companies more competitive. Trends have been similar in foreign markets, and this has combined with falling inflation and growing purchasing power to improve the outlook for Estonian exports. The baseline forecast is that the the economy will shrink by 0.4% in 2024, but will start to grow in the second half of the year despite this. Growth in the economy will pick up to 3% in 2025 (see key indicators for the forecast in Table 4 and comparison with forecasts by other institutions in Table 5).

Table 3. Forecast assumptions for government finances

	2024	2025	2026
Government sector GFCF (EUR billion)	2.7	3.0	2.8
Government sector wage fund (EUR billion)	4.8	4.9	5.1
Government sector intermediate consumption (EUR billion)	2.8	2.7	2.8

Sources: Ministry of Finance, Eesti Pank

Table 4.Economic forecast by key indicators*

	2022	2023	2024	2025	2026
Nominal GDP (EUR billion)	36.38	38.16	39.20	41.36	43.62
GDP volume**	0.1	-3.1	-0.4	3.0	3.2
Private consumption expenditures***	2.7	-1.6	0.0	3.9	2.9
Government consumption expenditures	-1.4	0.6	2.5	-2.8	0.5
Gross fixed capital formation	-10.5	8.8	-4.5	4.5	2.2
Exports	5.1	-9.0	-0.9	4.3	3.8
Imports	5.1	-6.6	0.3	4.0	2.6
Output gap (% of potential GDP)	3.0	-2.7	-4.4	-2.9	-1.6
CPI	19.4	9.2	3.5	3.3	2.5
HICP	19.4	9.1	3.6	3.2	2.4
GDP deflator	15.9	8.3	3.2	2.5	2.2
Unemployment rate (% of the labour force)	5.6	6.4	7.6	7.3	6.9
Employment****	4.6	3.2	0.5	-0.1	-0.4
Average gross wage (EUR)	1645	1832	1959	2053	2164
Average gross wage growth	11.7	11.4	6.9	4.8	5.4
GDP per employee	-4.4	-6.1	-0.9	3.1	3.6
Current account (% of GDP)	-3.9	-1.3	-1.9	-1.7	-0.5
Budget balance (% of GDP)	-1.0	-2.6	-3.2	-4.9	-4.1

* Numbers reported are annual rates of change in per cent, if not noted otherwise, ** GDP and its components are chain-linked, *** including NPISH, **** employment by domestic production units.
Sources: Statistics Estonia, Eesti Pank

Table 5. Estonian economic forecasts by other institutions

	GDP real growth, %					CPI inflation, %				
	2022	2023	2024	2025	2026	2022	2023	2024	2025	2026
Eesti Pank	0.1	-3.1	-0.4	3.0	3.2	19.4 19.4*	9.2 9.1*	3.5 3.6*	3.3 3.2*	2.5 2.4*
Ministry of Finance	0.1	-3.0	-1.0	3.3	3.0	19.4 19.4*	9.2 9.1*	3.8 4.0*	4.2 4.1*	2.2 2.3*
European Commission	-0.5	-3.0	-0.5	3.1		19.4*	9.1*	3.4*	2.1*	
IMF	-0.5	-3.0	-0.5	2.2	2.0	19.4*	9.1*	4.2*	2.5*	2.5*
OECD	-0.5	-3.1	-0.4	2.6		19.4*	9.1*	3.9*	2.1*	
Consensus Economics	0.1	-3.0	0.0	3.3		19.4	9.2	3.4	3.1	
Luminor	-0.5	-3.1	-1.0	1.0	1.0	19.4	9.2	4.0	5.0	4.0
SEB	-0.5	-3.0	-0.7	2.5	2.7	19.4*	9.1*	3.8*	3.5*	3.0*
Swedbank	-0.5	-3.0	-0.6	1.5	2.5	19.4	9.2	3.7	4.4	3.5

* HICP
Source: Eesti Pank, September forecast, 24.09.2024; MoF, Summer 2024 forecast, 27.0.2024; European Commission. European Economic Forecast. Spring 2024, 15.05.2024; IMF, WEO, April 2024, 16.04.2024; OECD, Economic Outlook, May 2024, 02.05.2024; Consensus Economics, Eastern Europe Consensus Forecasts, September 2024, 19.09.2024; Luminor forecast, 18.09.2024; SEB, Nordic Outlook, August 2024, 27.08.2024; Swedbank Economic Outlook, 27.08.2024.

Things will become better in export-oriented manufacturing, which is one of the sectors that has suffered the most. Export volumes increased in quarterly terms in the first two quarters of the year, and illustrate that there has already been some improvement in exports of goods. There remains quite a bit of uncertainty around the recovery in foreign demand, as the economic performance of Estonia's trading partners varies and the expected improvement in it has been pushed back to the second half of the year. The new upswing started from a very low base, and so the

aggregate results for export volumes for goods and services will not yet climb back to the level they were at last year. Demand from abroad will grow more strongly over the next two years though, and that will boost exports of goods. Exports of services will continue to increase throughout the forecast horizon, including this year, as demand will remain strong in the services sector for ICT services and business services. Overall inflation falling will support growth in travel services. The decline in transport services and the growth appearing in the second quarter as goods transport revived is an early indicator of the economy performing better moving forwards.

Estonian companies will gradually become more competitive in foreign markets. Estimates based on surveys confirm that competitiveness in foreign markets is expected to improve in the near future and an improvement in export orders in the first half of the year indicates that demand is returning. The problems caused by Scandinavian currencies depreciating have eased, as have price pressures from commodities and production inputs. The recession dragging on for more than two years has left companies with production capacity standing idle that can now be brought into use as demand returns. It should be noted though that not all of the idle capacity is necessarily still competitive and it cannot necessarily all be used to satisfy demand.

The recession ending and growth returning will increase the demand for labour in the second half of the year after a delay. The increase in employment in manufacturing this autumn will lead employment in the services sector to fall a little. Employers will still generally avoid redundancies though, and if possible will keep people in work in the expectation of growth in production volumes, as labour shortages are the dominant challenge over the long term. The unemployment rate will start to fall in 2025 as the economy grows, but this may happen slowly because of hoarding of workers and underemployment of them.

The labour supply will stop increasing. The number of refugees under temporary protection will fall, while the sluggish growth in the economy and the large amount of slack in the labour market will not encourage other immigration, and so the amount of labour available will not increase in the coming years at the same rate that it has done in the past couple of years. Wages in manufacturing have risen more slowly than the average in the economy, and so it has become less reasonable to hire foreign specialists in the manufacturing sector. Labour force participation is also expected to grow more reluctantly than it has been doing.

Growth in wages will continue to slow, as will the growth in the purchasing power of wages. The growth in the average wage will be restrained by slower growth in pay in the government sector and by high inflation no longer being passed through into wages. The growth in the gross wage in 2025 is also restrained in the baseline forecast by the planned change to the income tax system. The purchasing power of wages will still continue to increase, but the boost given to inflation by tax rises means it will do so more slowly than before.

Consumption volumes will rise. Lower interest costs will increase the purchasing power of incomes, and so also the real disposable income of households. This, together with improved confidence, will allow private consumption to increase. Purchases of cars may be expected to boost private consumption at the end of this year, as buyers look to avoid or defer the registration fee for vehicles that will apply from the start of 2025 by bringing their purchase of a vehicle forward to this year. Private purchases of cars will consequently fall in 2025, and the Ministry of Finance has taken this behaviour pattern into account in its draft law.

Investment will grow across a broad base as more and more sectors exit the recession. Production capital in the economy has so far grown most in energy production and ICT, but recovering demand at home and abroad will need investment to be increased in other sectors as well. Interest rates have fallen as Euribor has come down and as competition has caused loan margins to narrow. This will leave more money in the hands of borrowers, reduce the total cost of assets bought with loans, and so make investment cheaper.

Funding conditions will improve. The smaller banks that are mainly domestically owned have not lost any of their ambition to grow rapidly despite the higher cost of funds and their loss of competitiveness against the larger banks. This is good news for access to loans and the price of loans, as it puts downwards pressure on high interest margins. This has happened to some extent already with housing loans, but the banks will probably only dare to reduce the interest margins

on corporate loans once the economic climate is clearly improving. The banks face no serious obstacles to lending from capital or funding, and it is probable that lending will grow rapidly as demand for loans does the same.

PRICES

Inflation will start to pick up again in the fourth quarter of the year, as energy prices rise seasonally. Higher inflation in 2025 will be caused mainly by tax rises and prices regulated by the state. The car tax will be introduced at the start of next year and will raise total inflation by an estimated 0.6 percentage point, and probably be reflected in services prices[13]. Prices of corporate output will rise more slowly in the coming years as growth in wages slows, and also at the expense of profits. Inflation will be close to 2.5% at the end of the forecast horizon in 2026.

Price pressures from abroad will increase a little during the forecast horizon. Import prices, having fallen for a whole year, have started to rise again. Industrial commodities will be the main commodities that rise in price, while the reorganisation of supply chains will also cause price pressures to reach consumer prices from the supply side. Prices for food commodities may hold stable for some time, having risen this year. This assumption draws on the relatively good harvest this year. Prices of alcoholic drinks and tobacco in the consumption basket of consumers will continue to rise in the coming years because of high excise rates.

Energy prices are increasingly volatile. The insufficiency of production capacity and transmission capacity will keep electricity prices variable. The forecast uses the price fixed in electricity contracts that both electricity sellers and consumers use to calculate the long-term price risks. The price of gas has come down from its record levels of previous years, but network fees will rise because of low consumption volumes.

THE FISCAL POSITION OF THE GENERAL GOVERNMENT

The negative supplementary budget passed in the summer was intended to bring the budget deficit this year within the limits of the fiscal rules, but the performance of the economy has been poorer than was foreseen at the time of the supplementary budget. Under current assumptions the Estonian general government budget deficit will be a little over the 3% of GDP permitted by the fiscal rules at 3.2% of GDP.

Although private consumption and economic activity have remained quite weak throughout this year, hindering the growth in tax revenues, the rise in VAT at the start of the year will help increase tax receipts. The sharp rise in corporate income tax will help boost tax revenues further, partly also because the commercial banks have agreed larger profit distributions than usual. On the expenditures side there will be a major increase in spending on national defence, but the growth in spending on social support and in general government wage costs will be slower than last year.

Without the measures listed in the updated coalition agreement, the general government budget deficit will increase next year to 4.9% of GDP. This will happen mainly because of the reduction in the tax burden from changes to the personal income tax system. Receipts of income tax will be reduced sharply by the uniform basic exemption of 700 euros per month for every person of working age, and postponing that change would be one measure that would substantially improve the fiscal position next year (see the additional scenario). Under the fiscal plans, government investment will additionally be raised to a very high level in 2025, largely through investment in defence. The fiscal position will improve in 2026, mainly because spending on investment will be smaller, but current assumptions indicate that the general government budget deficit will again exceed the 3% of GDP permitted by the domestic and European Union fiscal rules.

ADDITIONAL SCENARIO TO THE FORECAST: THE OUTLOOK FOR THE ECONOMY IF THE NEW COALITION AGREEMENT IS FULFILLED

The current government announced its plans to bring fiscal policy back onto a sustainable track in the governing coalition programme

13 It was not yet known when the forecast was written how exactly Statistics Estonia will start to account for the car tax in the consumer price index.

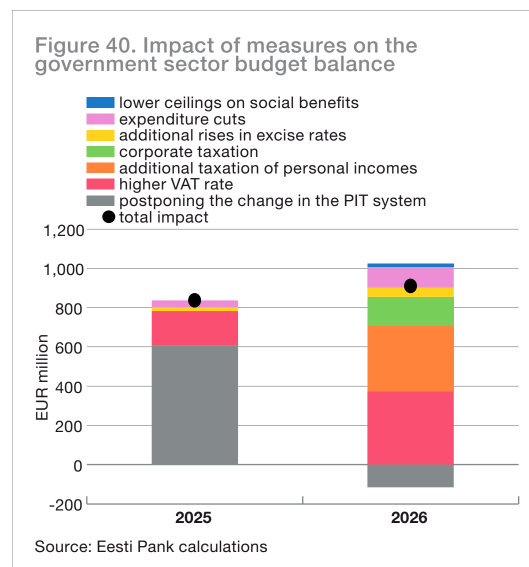
signed in the summer. The plans for the state finances described in the coalition agreement mainly concern changes to the tax system and an increase in the tax burden. No draft laws to enact these plans have yet been produced, but as it is quite probable that these plans will be followed through, this additional forecast scenario estimates the economic impact they will have.

The scenario takes account of the tax and general government expenditure measures as they are described in the coalition agreement and the summer forecast of the Ministry of Finance. It also considers the planned changes to social benefits such as the lower ceiling for parental benefits and changes to payments for sick leave. It does not assess the possible economic impact of other areas covered by the coalition agreement such as competitiveness, reforms or state administration because there is not sufficient information on them.

This additional scenario accounts for the postponement of the rise in the minimum tax-free threshold for income tax and its application to all working-age people to 2026; the rise in VAT to 24% on 1 July 2025; the implementation of an additional 2% tax on all personal incomes and the introduction of corporate income tax at 2% from 2026; further rises in excise rates; and cost savings and the application of needs-based social benefits, including the lower ceiling for parental benefits and changes to payments for sick leave.

The different fiscal policy from that used in the baseline scenario of the forecast changes the outlook for both economic growth and the fiscal position. The biggest fiscal impact comes from the postponement of the changes to the personal income tax system in 2025 to 2026, which would reduce the disposable income of households next year by over 600 million euros from the baseline forecast. The positive net impact on the budget is smaller than that though because the measure would restrict private consumption and consequently also tax receipts. The fiscal position next year would be improved by around 200 million euros from VAT being raised to 24% and

Figure 40. Impact of measures on the government sector budget balance



Source: Eesti Pank calculations

excises rising. This would pass through into lower private consumption as it did this year. Paying the additional 2% in personal income tax in 2026 would reduce the disposable income of households further and would improve the fiscal position by around 330 million euros once the economic adjustment has been accounted for.

If the coalition carries out its plans in the form described in the government coalition programme, the general government budget would be improved by 840 million euros in 2025 and about 910 million euros in 2026 (see Figure 40). This estimate considers the secondary effects of macroeconomic adjustment to the measures as well as the direct impact. The budget deficit would be reduced to 2.9% of GDP next year and 2.0% the year after.

The fiscal consolidation will have a substantial impact on growth in the economy, as the fiscal stimulus will be smaller than in the baseline forecast. A consequence of the economy recovering more slowly from its crises may be that the labour market suffers for longer and the fall in unemployment is put off into the more distant future. An important measure for reducing the deficit is the rise in indirect taxes, which will push consumer prices up faster and raise the cost of living (see Table 6)[14].

14 The impact assessment is based on the impulse response functions of the Eesti Pank macro model, which was made earlier to analyse the impact of fiscal policy for the joint forecasting exercise of the Eurosystem. It essentially consists of predefined scenarios for policy changes, such as increases in consumption taxes or changes to income tax, that take account of the different impact channels that the model does not normally consider when it is estimated.

Table 6. Economic forecast indicators if the coalition agreement takes effect*

						difference from the base projection	
	2022	**2023**	**2024**	**2025**	**2026**	**2025**	**2026**
GDP at current prices, billion euros	36.4	38.2	39.2	41.1	43.3	-0.3	-0.3
GDP growth at constant prices, %	0.1	-3.1	-0.4	1.9	3.0	-1.1	-0.2
Consumer price growth, %	19.4	9.2	3.5	3.9	3.6	0.6	1.1
Unemployment rate, %	5.6	6.4	7.6	7.7	7.6	0.4	0.7
Average gross wage growth, %	11.7	11.4	6.9	5.4	5.3	0.6	-0.1
Real wage growth, %	-6.5	2.0	3.3	1.4	1.7	-0.1	-1.1
Budget balance, % of GDP	-1.0	-3.5	-3.2	-2.9	-2.0	2.0	2.1

* Measures in the coalition agreement that have clear quantitative reference
Sources: Statistics Estonia, Eesti Pank