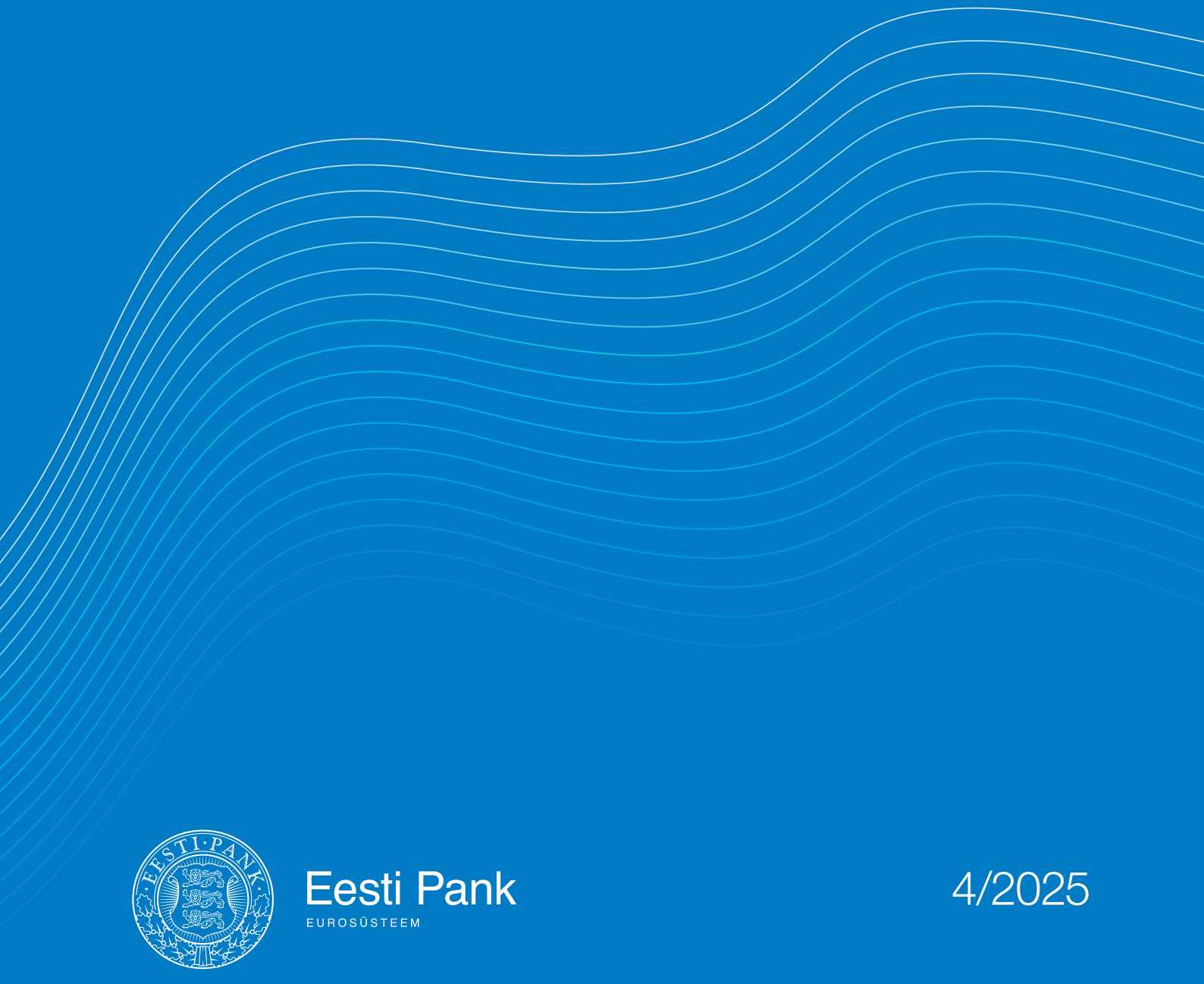
The Estonian Economy and Monetary Policy



Eesti Pank
EUROSÜSTEEM

4/2025

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.

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Online	ISSN 2504-6012
Layout and design	Urmas Raidma

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INTRODUCTION

The deterioration in terms of trade and the persistent geopolitical uncertainty have not yet particularly harmed the global economy. High tariffs have made cross-border trade more expensive, but the signing of some initial trade treaties has reduced uncertainty about future trade flows at least for now. The difficult geopolitical position and changes in international economic and political relations will make it harder to forecast the state of the economy in the coming years, as unexpected shifts in one or other direction could change the picture substantially.

If there are no unexpected events, the Estonian economy will recover and will revive even more clearly next year. The two factors that will start to support the economy above all in 2026 will be the growth in foreign markets and the fiscal stimulus from the state. Changes to the income tax system will increase people's purchasing power and the increased spending by the state will put more money than before into the economy. Low interest rates, good access to bank loans and falling infla-tion will also improve the outlook for the economy.

The general government budget will be in large deficit throughout the forecast horizon. Revenues and expenditures will diverge so far in 2026 that the budget deficit will be the largest of the past 30 years other than the pandemic-year budget of 2020. The main causes of the deterioration in the budget balance will be the change to the income tax system and the rise in spending on defence above 5% of GDP. The information available at present shows the budget deficit remaining deep throughout the forecast horizon until 2028. All of the additional fiscal stimulus will give a short-term boost to growth in the economy but will also bring an increasing interest burden. Questions about the sustainability of the state finances will become increasingly pressing.

Inflation will fall and people's purchasing power will increase. The effect of the motor vehicle tax will disappear from the inflation rate at the start of 2026, and the effect of the rise in VAT will exit the inflation figure in the middle of the year. Lower prices for food commodities are expected to pass through into retail prices at the same time, and inflation for food will decelerate. Slower growth in wage costs will help to reduce the high level of inflation for services. Although the fiscal stimulus and the sharp jump in domestic demand resulting from it will cause additional inflation pressures, they will be offset by faster growth in productivity and by companies being able to raise prices for their output more slowly than their input costs rise.

Increased economic activity means the outlook for the labour market is good. The number of employees did not fall as fast as output volumes during the recent recession, especially in manufacturing and construction, and so companies will at first be able to increase their production without rapidly hiring new employees. Employment will increase a little in 2026, but after that it will remain quite stable. Unemployment will fall gradually, but will mainly do so not through a rise in employment, but because the number of people active in the labour market will fall. The labour supply will be reduced by the population ageing and the obligation to stay in education being extended, but the general participation rate will still remain high in international comparison.

The average gross monthly wage will rise more slowly, but the changes to the income tax system will cause a sharp jump in net incomes. The changes mean that the average net wage will rise twice as fast in 2026 as the gross monthly wage, as it will gain around 10%. Inflation falling at the same time will increase people's real purchasing power substantially. Harmonising the tax-free threshold will at the same time reduce cost pressures for employers, and this will combine with the improving demand environment to let them recover the profitability they have lost in recent years. Labour costs have increased as a share of value added created to close to their historical peak, partly because employers have retained staff, and an improvement in corporate investment capacity requires this increase to go into reverse and the profit share to recover.

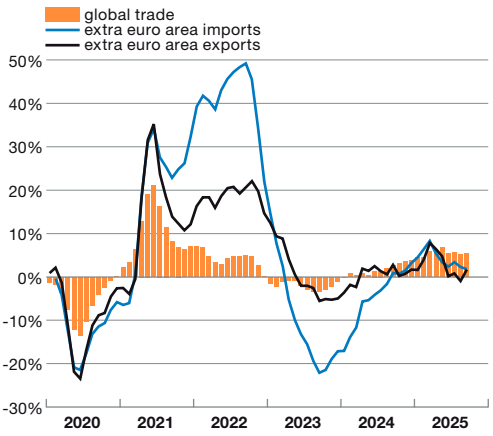
Interest rates will continue to favour borrowers. The bulk of the cuts to Euribor have by now already been made, and any further changes will be small, but the strength of the supply of credit from the banks will give support to both businesses and households. The majority of loans in Estonia, unlike those in most other euro area countries, have interest rates based on the short-term or six-month Euribor, and only a small share of loans have interest rates fixed for a longer time. The loosening of monetary policy consequently reached borrowers in Estonia much faster, and it will give support to the revival in the economy in the coming years.

THE EXTERNAL ENVIRONMENT

THE GLOBAL ECONOMY

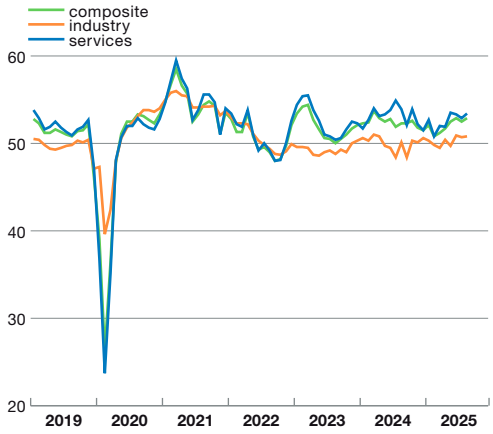
The global economy remained strong in the third quarter despite the introduction of protectionist tariffs and the increased uncertainty. The global economy will grow by 3.2% this year, which is 0.4 percentage point more than was forecast in the spring[1]. Growth has been faster than expected because of the increased investment in artificial intelligence, supportive fiscal policies, and the depreciation in the US dollar that has improved financing conditions and helped ease the impact of trade tariffs. A decline in uncertainty helped international trade as the protectionist tariffs turned out to be lower than feared and some trade treaties were signed (see Figure 1). Initial estimates indicate that the US economy continued to grow strongly in the third quarter, with investment by companies in data centres and more powerful chips for artificial intelligence, and in new corporate digital solutions taking the lead[2]. Quarterly growth in GDP in the United Kingdom slowed to 0.1%, while growth in the euro area economy picked up to 0.3% (see Table 1). The IMF warned though that higher trade tariffs have already reined back the earlier growth in exports from several countries, and so the tariffs will start to have a clearer impact on the economy moving forwards. Japanese GDP fell by 0.4% in the third quarter for example, reflecting the weakness in private consumption and a fall of 1.2% in exports after the US imposed a 15% import tariff on many Japanese goods in September. Initial data at the start of the fourth quarter show moderate growth in activity in the global economy, as the global PMI rose to 52.9 points in October (see Figure 2) with

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

Table 1. GDP growth in different regions in 2020 - 2025 (change, %)*

	2020	2021	2022	2023	2024	2025 Q2	2025 Q3	2025
World	-3.1	6.0	3.4	3.5	3.3			3.2
Advanced economies	-4.5	5.2	2.7	1.8	1.8			1.6
Emerging markets and developing economies	-2.1	6.6	4.0	4.7	4.3			4.2
Euro area	-6.0	6.3	3.5	0.5	0.9	1.6 (0.1)	1.4 (0.3)	1.2
United States	-2.2	6.1	2.5	2.9	2.8	2.1 (0.9)		2.0
China	2.3	8.6	3.1	5.4	5.0	5.2 (1.0)	4.8 (1.1)	4.8
Japan	-4.3	2.1	1.0	1.4	0.2	2.0 (0.5)	1.1 (-0.6)	1.1
United Kingdom	-10.3	8.6	4.8	0.4	1.1	1.4 (0.3)	1.3 (0.1)	1.3

* GDP at constant prices, quarterly growth over the previous quarter is in brackets
Sources: IMF World Economic Outlook (October 2025), OECD, Eurostat, National Statistics; 2025 is IMF forecast

1 IMF World Economic Outlook, October 2025.

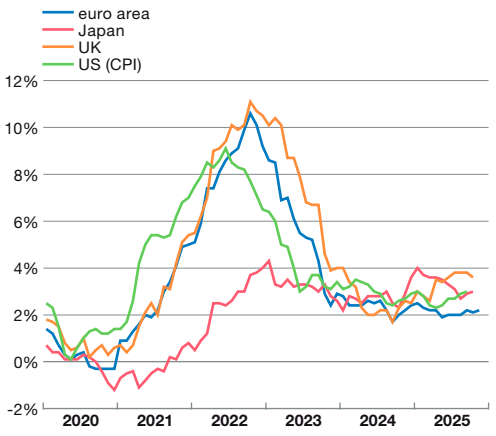
2 The government shutdown caused by budget negotiations delayed the release of the third-quarter GDP figure for the US to 23 December.

help from faster growth in services[3].

Global inflation is falling, but the additional price pressures caused by the US tariffs will be felt more and more. Inflation remains above the targets of central banks in several advanced economies (see Figure 3). Energy prices are no longer rising as fast, but food prices have continued to increase quickly in many countries. Central banks are consequently being cautious about easing their monetary policy. Inflation in the United Kingdom fell to 3.6% in October, which was its lowest level for four months. The Bank of England estimates that consumer price inflation has passed its peak and should gradually come down in future. The consumer price index in the US rose by 2.8% in November. The IMF estimates that the price pressures coming from the protectionist tariffs have not yet particularly affected the US consumer basket as a whole, but the rise in tariffs and the reorganisation of supply chains have made it harder for companies to cushion higher input costs using their margins. Future price pressures may consequently be passed through to consumers more. The Federal Reserve faces increased difficulties because of contradictory effects, as the tariffs have increased price pressures while the labour market is weakening at the same time and there is increasing political pressure to cut base interest rates.

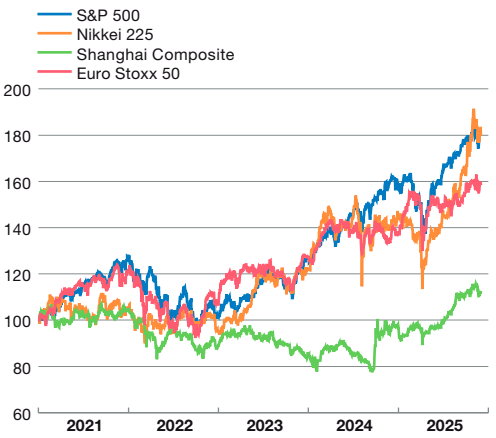
The IMF estimates that growth in emerging economies was a little over 4% in the second half of 2025. Growth has been slower in Latin America and Africa, as inflation has fallen slowly and high debt levels limit the capacity for economic development. Growth in Asia this year has been stronger than expected though, with support from growth in activity in the services sector and strong domestic demand. India stands out particularly as strong domestic consumption and public sector investment have contributed to growth, and this has helped soften the impact of the US tariffs. Growth in the Chinese economy slowed in the third quarter from 5.2% to 4.8%. Exports and the production of high-technology provided the main support for the growth, but weak domestic demand and the continuing decline in real estate restrained economic activity. Growth in exports was stronger in the third quarter than international institutions expected in the first half of the year. Exports of goods from China to the US dropped sharply at the same time though and were down 25% over the year in October, but they have increased to other Asian countries, indicating that new trade routes are being established. A preliminary trade agreement signed between the US and Chinese leaders in October gave some temporary relief from the tensions, but the high tariff rates will continue to limit trade between the two countries.

Figure 3. Inflation



Sources: Eurostat, Bloomberg

Figure 4. World stock indexes (01.01.2021 = 100)



Last observation 01.12.2025
Source: Bloomberg

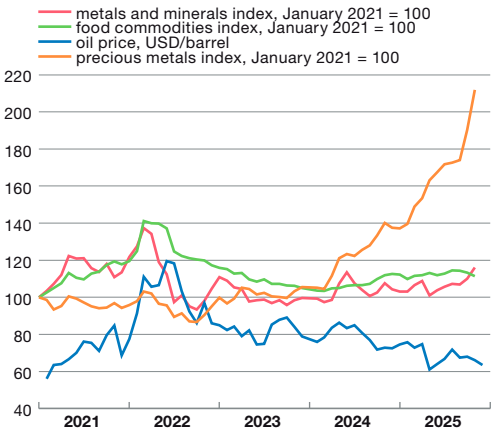
Global stock markets climbed to new peaks. Strong quarterly corporate results have driven the rise in US stock markets in the past three months and have not come only from the large technology companies (see Figure 4). The profits of the technology giants continued to grow fast, gaining 23% over the year, but the corporate results for the rest of the S&P 500 also improved by a notable

3 The J.P.Morgan Global Composite PMI Output Index.

12%. This was also reflected in the Russell 2000 index of small and medium-sized enterprises, which reached record high levels. Investors have however become more worried as share prices are at historically very high levels. This particularly concerns technology companies dealing with artificial intelligence, whose extensive investments and growing debt levels could cause a price correction in stock markets if they do not achieve the results that they are expecting. The largest stock markets in Europe have also mainly been rising and in some cases have reached new peaks with support from the good quarterly results and falling risk assessments of companies. The Nikkei 225 index in Japan reached the 50,000 point mark for the first time, reflecting optimism amongst investors over the outlook for the economy and the large fiscal stimulus provided by the government. The Shanghai Composite index in China climbed to its highest level of the past decade at the end of October on the back of hopes that trade tensions between the US and China would be eased.

Developments in the bond market were shaped by monetary policy decisions, fiscal risks and political uncertainty. The yield on the US 10-year Treasury fell a little in October and November, reflecting the decisions by the Federal Reserve about future interest rate cuts. Market participants became increasingly worried though that cutting interest rates at a time when inflation is still above its target and there remains political uncertainty about the independence of the Federal Reserve could increase inflation risks. The yield on US bonds will also be affected in the longer term by the extremely loose fiscal policy of the government, as the IMF forecasts that the US budget deficit will remain larger than 7% of GDP until 2030, which is the largest among advanced economies[4]. This will cause the indebtedness of the US government to grow by more than that of Italy or Greece by the end of the decade. The return on the German 10-year bond in the European bond market remained at around 2.7%, while the yield on French bonds rose above 3.4%. This is because of political instability and the concern about the ability of the government to take control of the deepening budget deficit. Yields in the Japanese bond market have been pushed up by the decision of the government to launch a support package for the economy worth around 21 trillion yen, or around 128 billion euros, which is the largest Japanese stimulus package since the pandemic. As this will increase the risks around servicing the government's debt, the yield on the Japanese 10-year bond rose to 1.9%, its highest level since 2008, and the return on the 30-year bond also reached a new historic record of 3.4%.

Figure 5. Commodity price indexes



Sources: The World Bank: Commodity Price Data (The Pink Sheet), Bloomberg, FAO

Commodities markets were affected by fluctuations in the oil price in the autumn and the continuing rise in the price of gold. The price of Brent crude fell a little (see Figure 5). The oil price was steered above all by the gradual increase in production by OPEC+ and the sanctions imposed by the European Union on oil exports from Russia together with the US sanctions on Rosneft and Lukoil. The price of gold continued to rise at the same time and it reached a new record level of 4300 dollars an ounce at the end of October. The price of gold has risen by 60% since the start of the year as prices of precious metals have been driven up by strong demand for safe assets. The rise in the gold price has been supported by the increasing popularity of exchange traded funds (ETF) that allow investors to invest in gold without purchasing the actual physical metal. The amount of physical gold held by the ETFs that invest in it has reached a level where those funds now hold the world's third largest gold reserves after the USA and the IMF. Prices for agricultural produce were mainly stable in the autumn as prices fell most for cocoa and oranges while those for coffee and beef rose a little.

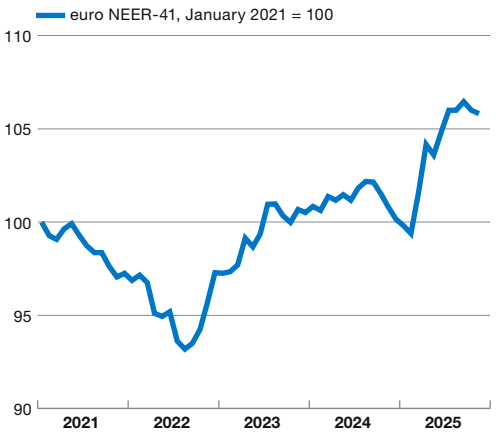
4 The IMF forecasts that general government gross debt will increase by over 20 percentage points and reach 143% of GDP by the end of the decade, exceeding even the earlier peaks seen after the pandemic (IMF Fiscal Monitor, October 2025).

THE EURO AREA

Growth in the euro area economy picked up in the third quarter. GDP growth in the euro area was 0.3% over the quarter in the third quarter of 2025, and it was 1.4% over the year. Growth in the euro area continues to be driven by the services sector, where there remains strong demand for tourism services and digital services among others. Spain again had the fastest growth in the euro area among the large economies, as GDP there grew by 0.6% over the quarter, mainly from private consumption and investment. The French economy grew by 0.5% at the same time, largely because of exports, while growth in the German economy was at a standstill, mainly because growth in exports was weak. The German exporting and manufacturing sector is suffering from weak foreign demand and the high US tariffs. Growth in the Italian economy was also close to zero in the third quarter, as value added in manufacturing fell and growth slowed in services. Overall the euro area economy has coped better than feared with the geopolitical risks and the uncertainty surrounding trade policy, though the situation varies between countries.

Estimates of economic activity in the euro area have improved, though there remain differences between sectors. The composite PMI[5] rose to 52.8 points in November, which is its highest level for two and a half years. This indicates that the economy has probably continued to grow in the final quarter of this year. The improvement in the composite index was mainly a consequence of the improvement in services, where the activity index rose in November at the fastest rate since May 2023. This came from growth in sales volumes resulting from strong demand and from new orders, which were sharply up in November. The manufacturing PMI[6] weakened a little though, and was just below the level of 50 points that marks the boundary of growth. There was also a further fall for the fifth consecutive month in new export orders in manufacturing, indicating that foreign demand for output from the euro area has not improved. Manufacturing companies consequently focused on meeting their existing orders and reducing their inventories. Expectations of manufacturing companies were however clearly above the long-term average level, which gives hope that economic activity is gradually increasing in manufacturing in the euro area. Business sentiment in the euro area[7] also continued to improve in November. Developments in manufacturing are however quite uneven across countries, and manufacturing in Germany and France, the two largest countries in the euro area, is facing the greatest difficulties. Activity in manufacturing in Spain meanwhile increased for the seventh month in a row.

Figure 6. Trade-weighted euro exchange rate



Source: European Central Bank

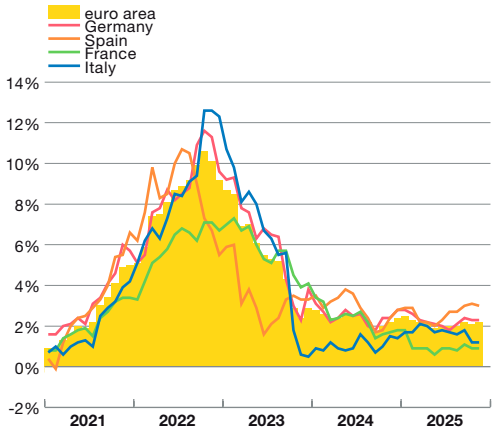
Growth in industrial output and retail sales continued to grow at a modest rate. Industrial output in the euro area was 1.2% larger in volume in September than a year earlier, which was the same as in the previous month. The growth was also marginally positive in monthly comparison, and was concentrated mainly in energy goods, capital goods and intermediate goods. Yearly growth in the volume of retail trade fell to 1,2% in September as sales of motor fuels dropped sharply. This was the slowest rate of growth since July 2024. The ongoing uncertainty is leading households to save more, but consumption continues to support the economy in the euro area. This is aided by the continuing growth in disposable income and improved sentiment among consumers in the autumn after it had weakened in the spring and summer. The trade surplus of the euro area widened to 19.4 billion euros in September, as exports increased by 7.7% over the year, mainly through exports of chemical products, while imports were up by 5.3%. The exchange rate of the euro (NEER) weakened in October and November after its sharp appreciation in the summer against the currencies of its main

5 The HCOB Eurozone Composite PMI® Output Index.

6 The HCOB Eurozone Manufacturing PMI.

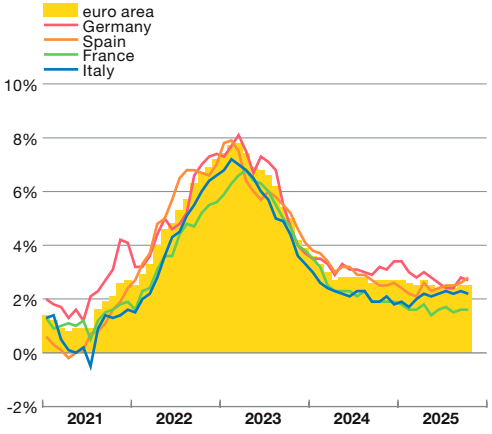
7 The Economic Sentiment Indicator (ESI), European Commission.

Figure 7. HICP inflation



Source: Eurostat

Figure 8. Core inflation

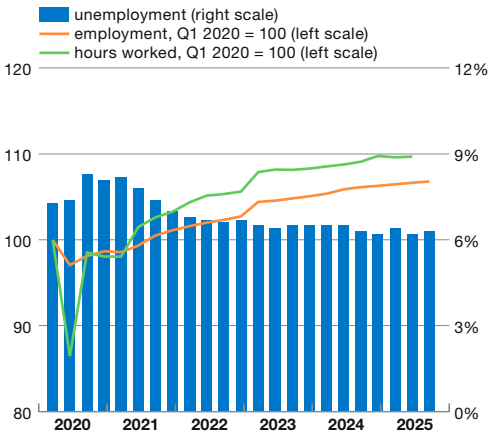


Source: Eurostat

trading partners, including the US dollar (see Figure 6). This should make companies in the euro area a little more competitive in foreign markets. The earlier loosening of monetary policy (see Box 1) has helped ease financing conditions, and this will support companies and investment in the euro area in the future.

Inflation in the euro area picked up from 2.1% in October to 2.2% in November (see Figure 7). Inflation for services increased to 3.5%, its highest level since April, while energy prices fell more slowly at the same time. There was no essential change in prices for manufactured goods or for food, alcohol and tobacco. Core inflation, which excludes prices for energy and food, alcohol and tobacco, was 2.4%, as it was in the preceding months (see Figure 8). Inflation rose in Germany to 2.6%, which is the highest figure since February and clearly above the Eurosystem's target of 2%, while it stayed the same in Spain at 3.2%. Overall inflation was also lower in France at 0.8% and Italy at 1.1% as service prices there rose more slowly than elsewhere. The labour market in the euro area remains good and the unemployment rate is very low at 6.4% (see Figure 9). Youth unemployment is increasing though and

Figure 9. Employment and unemployment in the euro area



Source: Eurostat

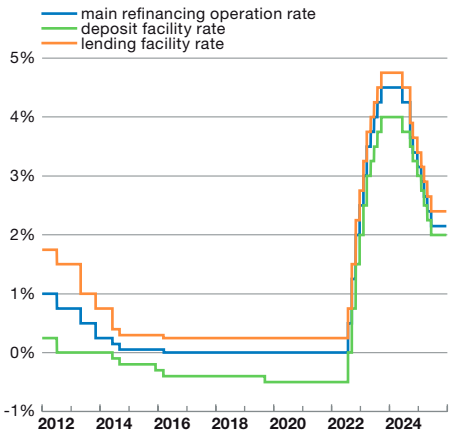
developments in some sectors are again hampered by a shortage of specialists[8]. The number of people in employment grew more slowly in the third quarter, as it gained 0.6% over the year. Wage growth in the euro area is slowing a little at the same time and was 3%. Negotiated wages are rising notably more slowly though, and growth in them was 1.9% in the third quarter. This means that internal price pressures in the euro area have eased.

8 ICT, construction, medicine and engineering.

Box 1: Monetary policy in the euro area

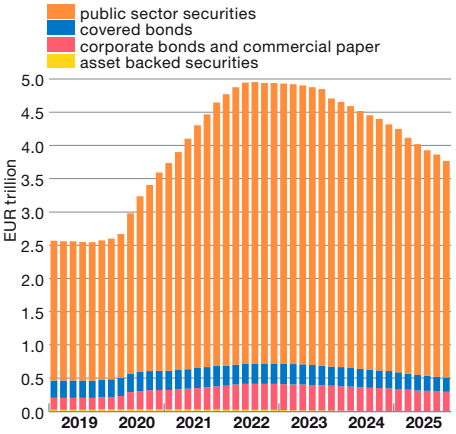
The primary objective of the Eurosystem monetary policy is to maintain price stability in the euro area. The European Central Bank defines price stability as annual inflation of 2% over the medium term. Inflation in the euro area has held around this target of late. Food prices are rising less quickly, energy prices are lower than they were a year earlier, and wages are no longer rising as

Figure B1.1. Eurosystem key interest rates



Last observation 18.12.2025
Source: European Central Bank

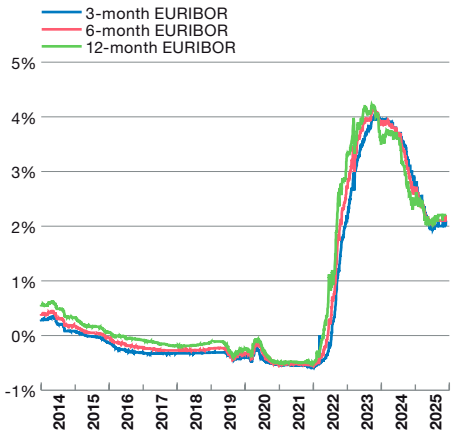
Figure B1.2. Eurosystem holdings under asset purchase programmes (APP and PEPP)



Last observation 30.11.2025
Source: European Central Bank

fast. The December forecast by the Eurosystem foresees that inflation in the euro area will fall to 1.9% in 2026 and 1.8% in 2027, and will then pick up to average 2% in 2028. The outlook for inflation shows the rate of it staying very close to the target of the central bank, and so the Governing Council of the European Central Bank has not changed its monetary policy at its recent meetings.

Figure B1.3. Euro area money market interest rates



Last observation 27.11.2025
Source: Bloomberg

The Governing Council decided at its meetings in October and December to leave its key interest rates unchanged (see Figure B1.1). The interest rate on main refinancing operations is 2.15%, the marginal lending rate is 2.40%, and the deposit facility rate is 2.0%. The Governing Council emphasised that it is not pre-committing to a particular rate path moving forwards. The uncertainty stemming from trade policy remains large and inflation may be affected in either direction by various other factors. The Governing Council's policy rate decisions will continue to 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.

The balance sheet of the Eurosystem is shrinking. This was happening in earlier years because of the termination of the programmes of lending on favourable terms during the Covid-19 pandemic[9], but it is now happening because the portfolios of bonds bought under the various asset purchase programmes are maturing[10]. The total value of bonds purchased under the asset purchase programme (APP) and the pandemic emergency purchase programme (PEPP) on the balance sheet of the Eurosystem at the end of November was 3.8 trillion euros (see Figure B1.2).

As the Governing Council did not change its key interest rates at its most recent meeting and as

9 The volume of longer-term refinancing operations on the balance sheet of the Eurosystem has fallen since the start of 2022 by around 2.2 trillion euros to 11 billion euros.

10 The Eurosystem is no longer reinvesting the principal repayments received from maturing securities. Reinvestment of bonds purchased under the asset purchase programme (APP) was discontinued in July 2023 and reinvestments under the pandemic emergency purchase programme (PEPP) were discontinued at the end of 2024.

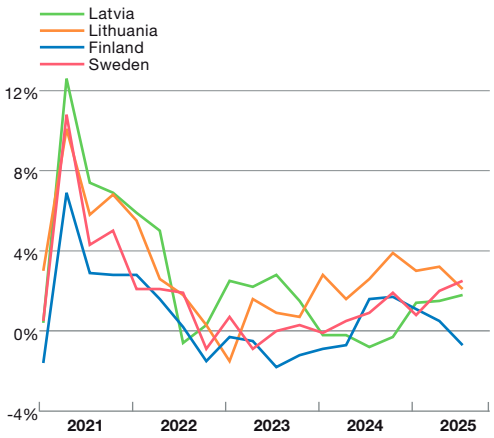
market participants do not expect any major changes in monetary policy in the near future, the interest rates in the interbank money market have remained relatively stable (see Figure B1.3). As at 27 November the 3-month Euribor was at 2.06%, the 6-month Euribor was at 2.11%, and the 12-month Euribor was at 2.21%. The growth in the broader M3 indicator of the money supply in the euro area has slowed a little, and it was 2.8% over the year in October. Yearly growth in non-financial corporate borrowing has stabilised in recent months, and was 2.9% in October. Yearly growth in borrowing by households increased to 2.8%. The Governing Council considers that key interest rates at their current level will continue to support growth in lending moving forwards and that the capitalisation and liquidity of the banks in the euro area remains strong.

ESTONIA'S MAIN TRADING PARTNERS

The economies of Estonia's trading partners developed in different directions in the third quarter of the year. Growth in the Swedish economy was surprisingly positive as GDP increased by 1.1% in the quarter, with support from a general improvement in sentiment and an upswing in private consumption. The Latvian economy also posted strong growth of 0.6% over the previous quarter, and this growth was broadly based. Latvian GDP was driven upwards by household consumption, investment, and the manufacturing, construction and retail sectors. Yearly growth in GDP also picked up speed to reach 2.6% in Sweden and 2.5% in Latvia (see Figure 10). The Finnish economy by contrast contracted by 0.3% in the third quarter, which was the second consecutive quarter of decline. The decline was caused by multiple government spending cuts and a reduction in investment, and also by a fall in household spending and the housing market and construction remaining weak. Growth had been fast in the Lithuanian economy but stalled unexpectedly in the third quarter, when GDP growth over the quarter was 0% as general government spending and industrial output declined. Growth over the year in GDP in Lithuania slowed to 2%.

Survey data and data on the non-financial sector confirm the differences between countries. The PMI for manufacturing in Sweden[11] continued its firm upward trajectory in November and was clearly above 50 points as orders increased, mainly on the back of domestic demand. Data from corporate surveys continue to indicate caution in manufacturing though[12].

Figure 10. Yearly growth rates of GDP of trading partners



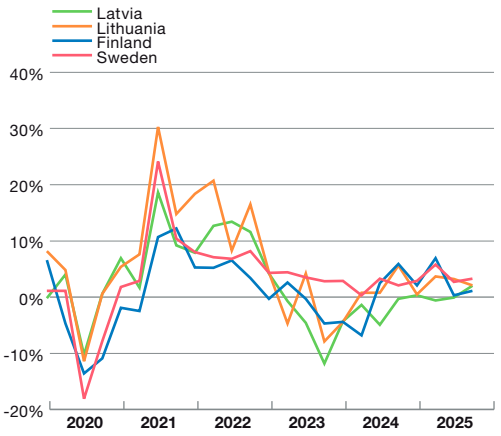
Source: Eurostat

Sentiment indexes for Latvia indicate increasing optimism among businesses and consumers, which is in line with the economy recovering. There have also been signs of strong yearly growth in industrial output volumes of above 8% in Latvia in recent months. Wood processing was a sector that performed better in Latvia, as did producers of electronics and machinery and equipment. Consumer confidence in Finland remains quite weak, as unemployment is high and so consumers would rather save than spend. Corporate confidence is also below its long-term average level, though expectations have improved a little. Growth in Finnish exports accelerated in the third quarter (see Figure 11) as a large cruise ship reached completion, but net exports remained negative as imports grew by even more. Signals about economic confidence in Lithuania are contradictory, as consumer confidence remains good and the volume of retail trade is growing together with that, but the mood in industry

11 Sweden's Swedbank Manufacturing PMI.

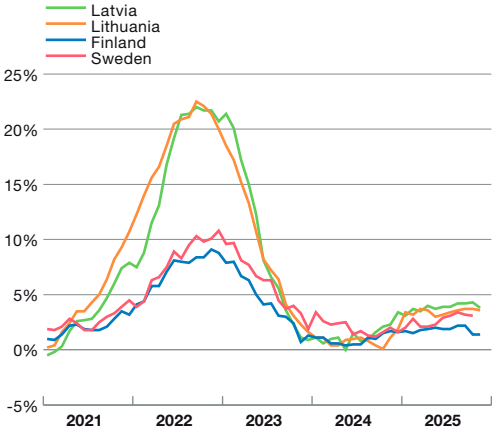
12 Riksbank's Business Survey.

Figure 11. Yearly export growth of trading partners



Source: Eurostat

Figure 12. HICP inflation of trading partners

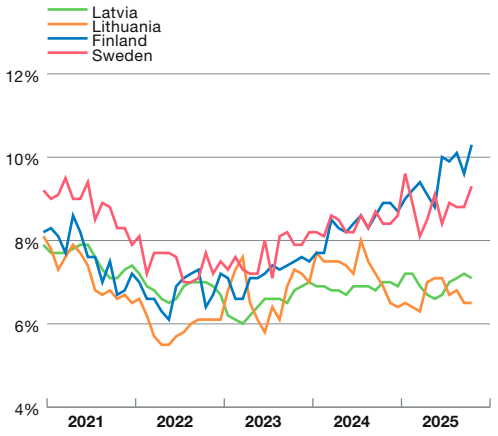


Source: Eurostat

became a little more pessimistic during the autumn. The growth in industrial output volumes is also lower than before.

The indicators for inflation have improved. Inflation in Sweden[13] is at 2.2% (see Figure 12) and although it has come down it remains above the target level of the Swedish central bank, as service price inflation is sticky while price pressures for goods and food have moderated, partly because the Swedish krona has appreciated. Inflation expectations are anchored and the temporary cut in VAT on food that will come into force next April is helping reduce inflation further. Inflation is very low in Finland and was only 1.4% in November, while in Lithuania it remained high at around 3.6%, partly because of rises in excises. Inflation was almost 4% in Latvia in November, mainly because of rises in housing costs and prices for services. Wage growth in Estonia's trading partners is generally slowing, but it continues to exceed inflation and so support the real incomes and consumption of workers. Unemployment remains high in those countries though at around 7-9% (see Figure 13). The lack of recovery in construction has been one

Figure 13. Unemployment rates of trading partners



Source: Eurostat

of the factors putting pressure on the labour market in Finland, and the Finnish economy continues to perform poorly. The improvement in the Swedish economy has not yet passed through into the labour market[14], while the problem in Latvia and Lithuania is more one of regional unemployment and the mismatch between the skills of employees and the needs of employers.

13 HICP.

14 The labour market usually reacts to changes in the economy with a lag.

THE ESTONIAN ECONOMY

ECONOMIC ACTIVITY

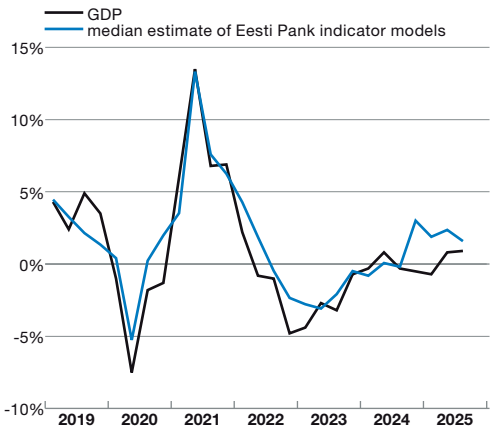
Short-term indexes of economic activity showed some decline in activity in the third quarter. Various short-term indicators over the past year have shown the economy strengthening faster than indicated by the official GDP statistics (see Figure 14), but the growth they show slowed in the third quarter and so the consistency with the GDP statistics has improved. Slower growth in trade may be explained by the temporary impact of the rise in VAT, while for manufacturing the external environment remains uncertain. Data from Statistics Estonia show that Estonian GDP in the third quarter was 0.9% larger than a year earlier and 0.4% larger than in the second quarter.

Growth received a lot of support in the third quarter from the public sector, which increased its investment and spending on consumption. Investment increases the capital stock and thereby raises potential growth. The calculation of potential GDP assumes however that although the increase in general government investment offsets the decline in private investment, the contributions of private and public investment to potential growth are not identical. It is assumed in this context that public sector investment being higher than usual, primarily because of spending on defence, does not increase the supply capacity of the economy or potential GDP. While these investments still increase the capital stock, the faster growth of capital is offset by slower growth in total factor productivity (see Figure 15).

Estimates of the business cycle based on corporate surveys have improved in recent months. They still indicate that the economy is performing below its long-term average level (see Figure 16) but the picture has become better. With growth in the economy relatively slow, this is in line with potential growth being weaker than before. Returning to a normal position will need demand to strengthen noticeably, as companies still have sufficient spare production capacity and the restraining effect of labour shortages on growth is below the average.

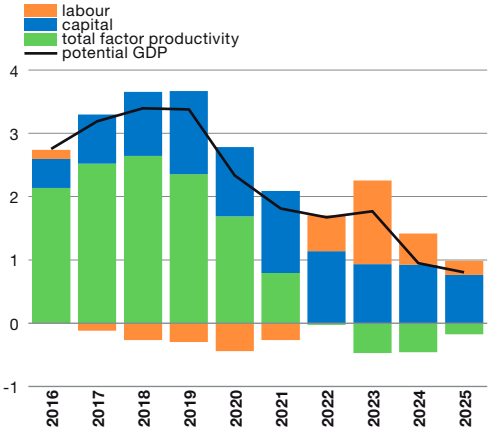
Growth in exports at constant prices was fast, but it is hard to relate this to developments in the domestic economy as the growth in the export turnover of manufacturing was substantially

Figure 14. Yearly GDP growth



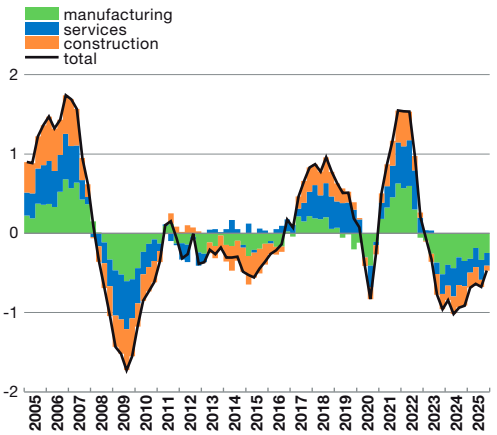
Sources: Statistics Estonia, Eesti Pank

Figure 15. Potential GDP growth



Source: Eesti Pank

Figure 16. Standardised survey indicators of the business cycle

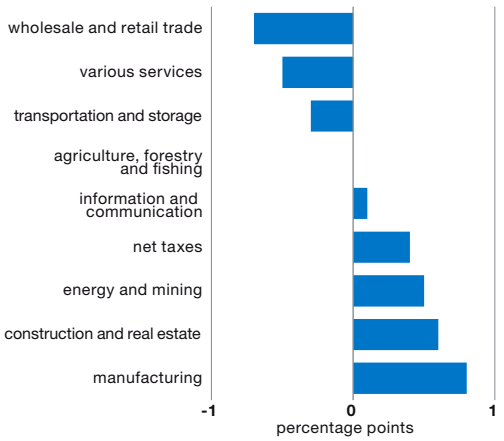


Sources: European Commission, Eesti Pank

smaller, and the growth in value added across branches of private sector services was quite modest (see Figure 17). These dynamics suggest that exports largely consisted of imported goods and services.

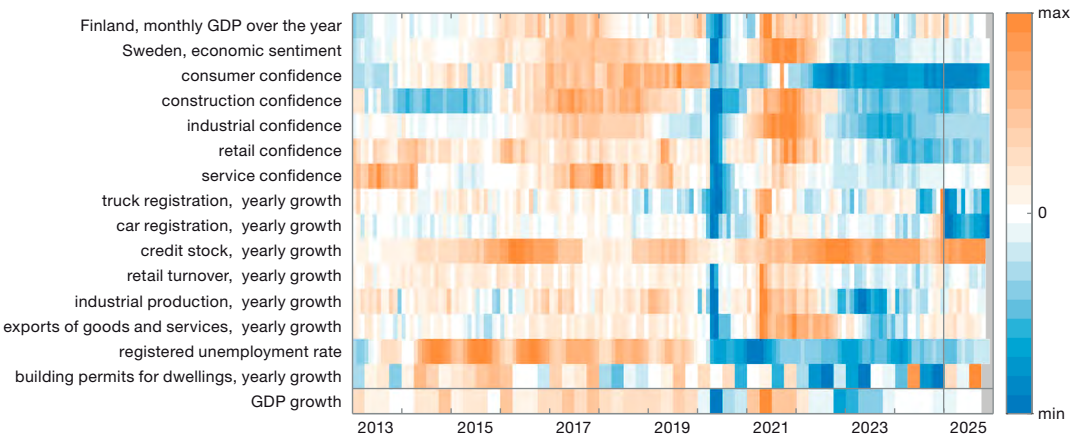
It was surprising branches of the economy that provided a large part of the growth in the economy in the third quarter, and their good performance was not reflected in output volume indexes. The value added by energy was up by more than 20% over the year for example, even though production volumes were down by the same amount. Value added in manufacturing grew similarly at a fast pace, though the growth in output from the sector was relatively modest.

Figure 17. Contributions to GDP growth by sector in Q3 2025 from Q3 2024



Sources: Statistics Estonia, Eesti Pank

Figure 18. Heatmap of the Estonian economy

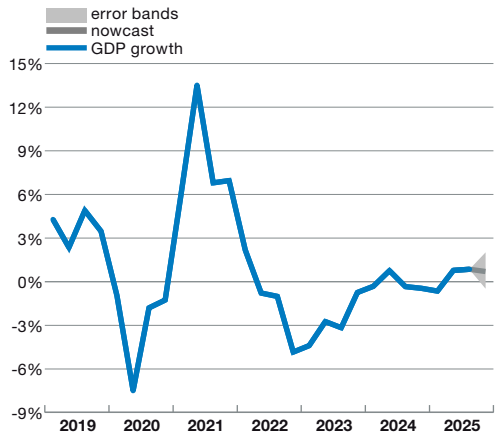


Sources: Reuters, European Commission, Eesti Pank, Statistics Estonia.

Industrial output was smaller in October than a year earlier in both energy and manufacturing. Expectations for production in the coming months were positive in manufacturing in September and October, indicating future growth, but they became more pessimistic again in November and fell into negative territory.

There are few data available on economic activity in the final quarter of this year, but what there are appear to indicate that performance in Estonia and in neighbouring countries was about the same or a little better than in the third quarter (see Figure 18). The Economic Sentiment Indicator in Sweden is only 0.6 points short of 100, and although confidence has turned positive in Estonia only in the services sector, there has been a gentle trend of improvement in the other areas. The October

Figure 19. GDP growth and current quarter nowcast



Sources: Statistics Estonia, Eesti Pank.

figures for manufacturing and retail did not show any rapid growth, but expectations for output had improved a little and a revival in foreign trade allows for some optimism.

It should be noted when interpreting the nowcast for the the fourth quarter (see Figure 19)[15] that the Eesti Pank activity indicator based on monthly inputs and the dynamics of GDP growth have become decoupled. This was especially so in the fourth quarter of last year, as the monthly indicators pointed to strong growth, but the latest estimate of GDP growth for that quarter is negative. The slower growth that is now indicated by the monthly indicators may consequently not appear in the figures for GDP growth because of the weak comparison base. Earlier experience has shown though that Statistics Estonia subsequently revises its GDP statistics and sometimes quite substantially, and this may make the GDP forecasts less accurate (see Box 2 on revisions of GDP data).

15 The nowcast produced by the Eesti Pank indicator model is a technical regression-based forecast that takes in data as they are received. There are fifteen models in the set and the nowcast is the median of the individual forecasts. The uncertainty related to the forecast is indicated by the mean historical absolute nowcast errors.

Box 2: Flash estimates and revisions of GDP growth

Eesti Pank, like other institutions that make economic forecasts, bases its assessment of the performance of the economy on various statistical data, among the most important of which is the figure for gross domestic product or GDP. The accuracy of forecasts of economic growth is consequently highly dependent on the quality of the GDP data, primarily whether the initial estimates are correct and how much they are later revised by. Large revisions to the statistics mean that there is inaccuracy in the underlying data for the forecast of economic growth, while smaller adjustments mean the forecast is more accurate. The forecast for growth also becomes a moving target in itself that may be shifted later in one direction or the other.

The first estimate of growth in the economy issued by Statistics Estonia is the flash estimate released a month after the end of the quarter, which gives a preliminary picture of growth in the economy based on limited data. The first estimate for the economy as a whole is given two months after the end of the quarter, and it is then subsequently adjusted regularly and irregularly[16].

After a pause of a few years and an adjustment to its methodology, Statistics Estonia started to release the flash estimate of GDP again at the start of 2023[17]. The flash estimate of GDP is found by econometric modelling that uses the information available at the time and the trends forecast for the months ahead. Statistics Estonia explained in a press release that they use indicators for trade, statistics on transport and manufacturing, tax declarations, figures for energy production, and price data to create various models of the Estonian economy. The flash estimate for GDP that is found using the statistical models is not methodologically comparable with the official figure for GDP that accounts for all of the transactions in the economy.

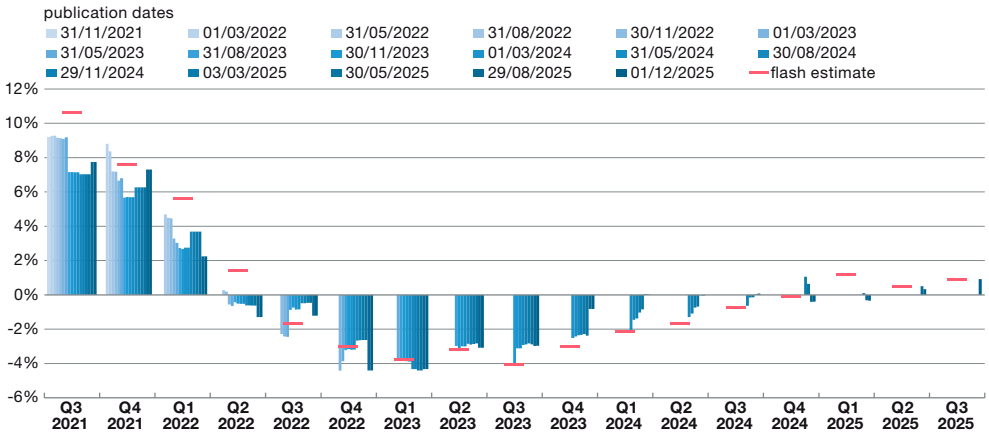
This box considers how the estimates for economic growth have been revised over time. The horizontal lines in Figure B2.1 show the flash estimates for yearly GDP growth, and the columns show the subsequent estimates of GDP growth for each quarter observed. It emerges that the first estimate, which was for the third quarter of 2021[18], has by now been revised 17 times, while the most recent estimate for the third quarter of 2025 has been revised only once. This period also saw the incorporation in 2024 of the larger methodology change that is made on a five year cycle. The figure appears to show at first glance that there is a systematic bias in the flash estimate, as the flash estimates when growth is positive are more optimistic than the subsequent revised

16 The comprehensive annual corporate financial reports known as EKOMAR are received 21 months after the end of the reporting year, and the main supply and use tables are received as much as 36 months after it.

17 https://www.stat.ee/et/uudised/skp-kiirhinnang-toenaoliselt-oli-majandus-eelmise-aasta-neljandas-kvartalis-languses (Estonian only).

18 The flash estimates for the years before 2023 were compiled using the same methodology and using only the data that were available in real time.

Figure B2.1. Yearly GDP growth by quarter

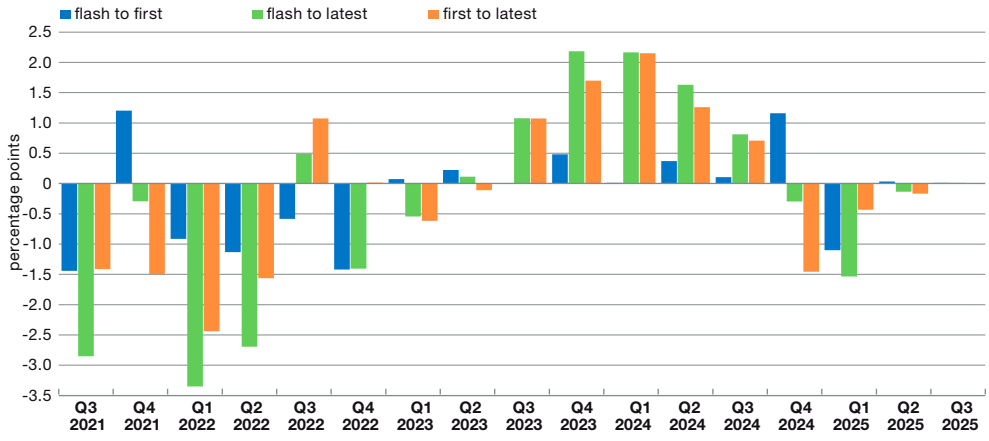


Source: Statistics Estonia

estimates, and so the horizontal line is higher than the columns. The opposite happens during a recession, when the flash estimate is excessively negative and the subsequent corrections take the figures for yearly GDP growth upwards.

The revisions to the estimates over time are studied here in three ways by comparing the flash estimate with the first estimate, the flash estimate with the most recent estimate, and the first estimate with the most recent one. Figure B2.2 shows the extent of these three revisions in percentage points.

Figure B2.2. Size of the revisions of yearly growth



Source: Statistics Estonia

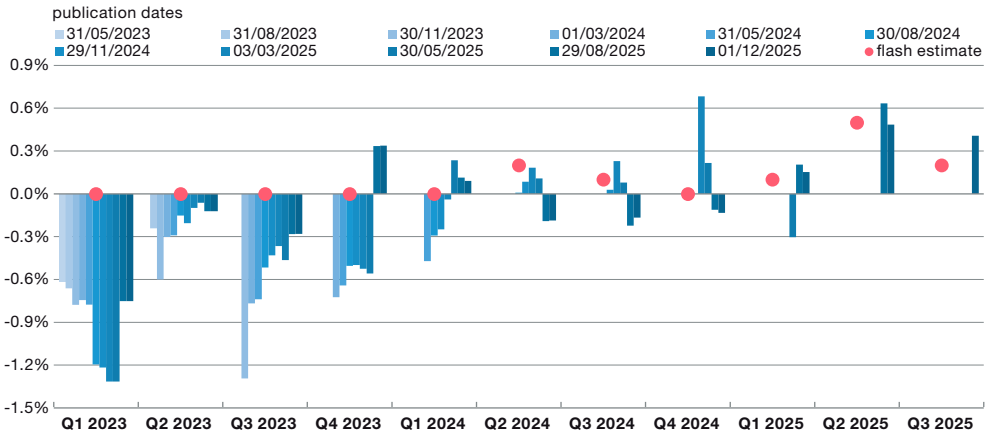
The blue columns show the difference between the flash estimate and the first estimate, with a negative value indicating that the flash estimate has been adjusted downwards and a positive one indicating that the first revised estimate is higher than the flash estimate. Corrections both upwards and downwards have been made during the period observed. The gap between the flash and first estimates averages -0.2 percentage point, but the average absolute difference is 0.6 percentage point. Corrections of more than one percentage point were made in about 40% of cases. It may be noted though that the first revision has not always been made in the same direction, and the direction of the initial revision does not predict those of subsequent corrections.

The green columns show the gap between the flash estimate and the latest data available. The extent of the correction becomes larger over time and so the average absolute difference in this case is as wide as 1.3 percentage points.

The difference between the growth series using the latest data available and the first estimate, which is shown by the orange columns in Figure B2.2, has an average absolute value of 1.1 percentage points. This means that the difference to the estimate using the latest data is of about the same magnitude whether the flash or first estimate is used as the starting point.

Statistics Estonia releases flash estimates and subsequent estimates and quarterly changes in GDP alongside its figures for yearly growth. Quarterly growth is not published in the official tables, but it is usually referred to in the press releases. Those press releases may sometimes use words rather than figures, saying for example that GDP was at the same level as in the previous quarter. An estimate phrased like this in a press release is taken to indicate growth of 0% so that the calculations that follow can be made[19]. Figure B2.3 shows the flash estimate with dots and subsequent estimates with columns and reveals that the first revision generally adjusts quarterly growth to be more negative. The changes have in some cases been quite large. The period used here for the comparison mainly covers the recession though, and so it is understandable that the additional negative information coming in over time has pushed Statistics Estonia to revise their flash estimates downwards.

Figure B2.3. Estimates of quarterly growth



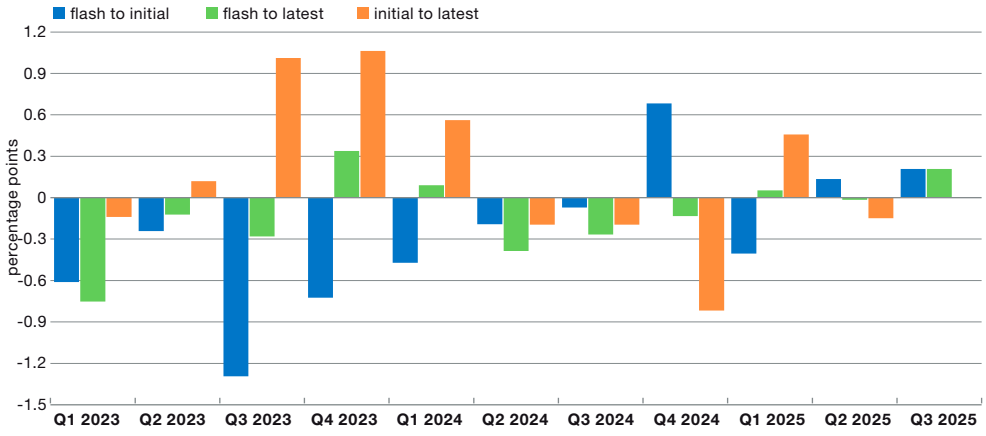
Source: Statistics Estonia

Figure B2.4 compares the flash estimate for quarterly growth with the first estimate in the blue columns and with the latest estimate in the green columns, and compares the first and most recent estimates for each quarter in the orange columns.

It shows that the blue columns are mainly on the negative side, confirming that the flash estimate is mainly adjusted downwards in the first round, and the average absolute gap to the first estimate in this period was 0.5 percentage point. The latest known growth figure differs from the flash estimate by an absolute 0.2 percentage point, indicating that the estimates move over time back towards the flash estimate. The average absolute difference between the latest estimate and the first estimate is also 0.5 percentage point.

19 The same wording has nevertheless also been used for quarterly growth of 0.1% or 0.2%. The substitute value of 0% may consequently under or overestimate the actual figure.

Figure B2.4. Size of the revisions of quarterly growth



Source: Statistics Estonia

There is however no very clear pattern in the direction that the corrections take. The revisions to the estimate of GDP growth over time mean though that some caution is needed when considering the latest data points. It should also be remembered that there is a moving target when forecasts are compared with the actual data.

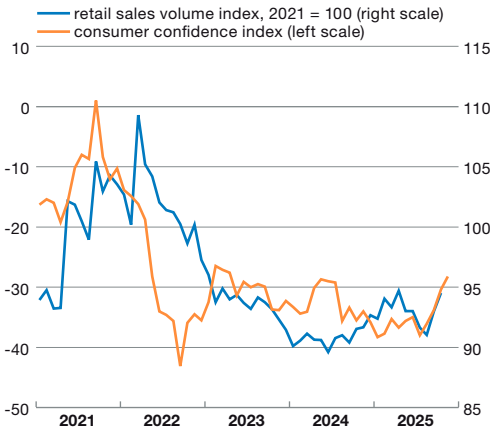
DOMESTIC DEMAND

Domestic demand was supported by the general government in the third quarter, but private consumption and corporate gross fixed capital formation declined.

Private consumption was 0.6% lower in the third quarter than a year earlier. The tax changes that have been introduced over the past year have made consumption more volatile, and that pattern was seen once again. Consumption increased in the second quarter as large purchases were brought forward in advance of the planned rise in VAT in July. Consumption then dropped in the third quarter once the higher taxes had started to apply. Sales of vehicles were still lower than a year earlier, and people make fewer visits to hotels and restaurants. Monthly data indicated though that the rise in VAT in July did not particularly discourage consumers, as the index of sales volumes in shops was only down in August. The rise in numbers for card payments, which also cover purchases and payments for services from online stores, was faster than inflation.

The monthly statistics indicate that consumption increased at the start of the fourth quarter. Sentiment surveys show that consumers have started to shake off their persistent pessimism since the start of August (see Figure 20). One cause of this may be the changes to the income tax system that will start to apply from next year and that will increase the disposable income of households in January. As the mood among consumers started to improve, so sales started to increase again in shops in the autumn. The growth in retail sales in September and October was driven mainly by increased sales of vehicle fuels as chains of petrol stations cut their prices, and by purchases of manufactured goods including electronics.

Figure 20. Retail sales and consumer confidence



Sources: European Commission, Eesti Pank

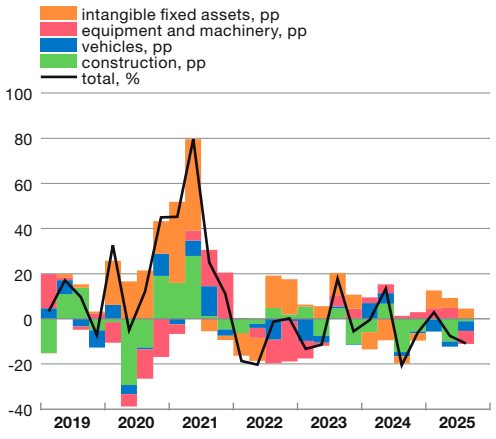
The strong labour market combined with disposable income continuing to increase as Euribor and average interest margins fell has revived the housing market as well. Investment by households in residential space was 12% more in the third quarter than in the same quarter of last year. The supply of new residential space has increased together with demand, as there was 27% more new space with construction permits in the first three quarters of 2025 than in the same quarters of last year, and 7% more with permits for use.

Productive capital has mainly increased in 2025 through general government investment (for more see general government financing) while corporate investment as a ratio to GDP has shrunk at the same time. Although the Estonian economy has been growing since the start of the year and the climate for financing has become more favourable, this has not yet increased the need to expand production capacity.

Gross fixed capital formation by companies was about a tenth smaller in the third quarter than in the previous quarter or in the third quarter of last year (see Figure 21), and the decline was broadly based across various sectors. Capital formation has mostly declined in recent years in buildings and structures, as high interest rates, weaker potential for growth and deep uncertainty hit projects for expansion first of all. However, there was a sharp drop in the third quarter in investment in machinery and equipment as well, which has a larger effect on productivity than investment in construction. The upwards trend in acquisition of intangible assets was maintained though through spending on software, patents and research and development activities.

Companies have a good opinion of the credit environment. Increased demand for loans, the good ability of banks to provide them, and falling interest rates all helped the stock of corporate loans in Estonia to grow by 8% over the year at the end of October, while the stock of housing loans was around 10% larger than a year earlier. The sectors with the strongest growth in borrowing were real estate, and professional, scientific and technical activities. Lending to manufacturing companies also posted growth at the same time, which reached 7%.

Figure 21. Corporate investment



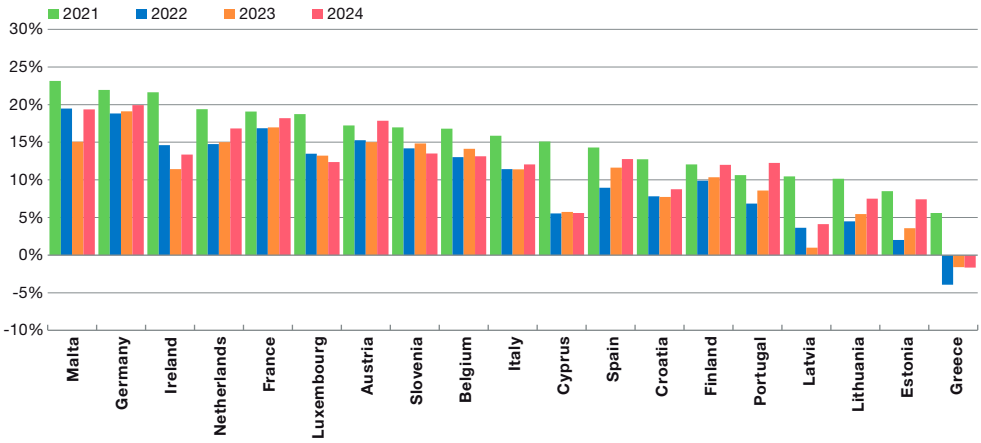
Sources: Statistics Estonia, Eesti Pank

The growth in corporate inventories in the third quarter gave a positive contribution to growth in GDP as well. The fastest growth in inventories over the quarter came from purchases of goods held for sale, mainly in retail and wholesale. This indicates that merchants expect trade and sales to prove lively in the fourth quarter. Manufacturing companies that saw the largest growth in inventories were those working in wood processing and in food processing. The growth in stocks of commodities for food processing and of materials coincides with expectations for output among companies across the whole sector, which were notably improved in the third quarter.

Box 3: The dynamics of household consumption and saving when interest rates were rising fast

A higher saving rate at times of anxiety is usually an indicator of caution among consumers, while a low saving rate points to increased confidence and higher consumption. High inflation in 2022–2023 coincided in Estonia with relatively low confidence and a decline in both consumption and saving. This box considers how the growth in the financial assets of households points to a higher saving rate than that shown in the statistics, and how the impact of higher interest expenses on consumption depends on the structure of households.

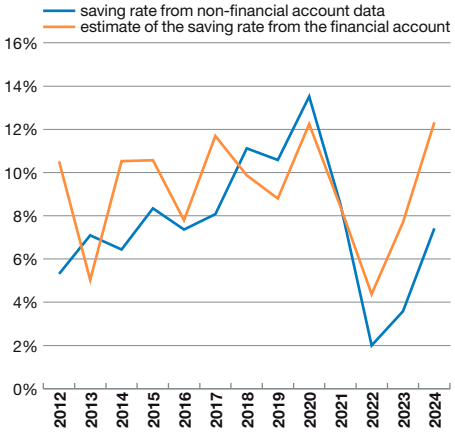
Figure B3.1. Household saving rate in euro area countries



Source: Eurostat

Household consumption at constant prices was 3.5% lower in the third quarter of 2025 than at its peak in the first quarter of 2022, which is one of the largest falls in the euro area. As consumption fell, so did saving at the same time. Households saved around 8-9% of their disposable income in 2018-2019 and even more during the pandemic, but data from Statistics Estonia show that the saving rate in 2022, showing the share of disposable income that went into savings, was down to 2% and was one of the lowest in the euro area (see Figure B3.1). This was also the time when the inflation rate was among the highest in the euro area.

Figure B3.2. Saving rate of households



Sources: Statistics Estonia, Eesti Pank

This low saving rate does not however fit with the figures from the financial account showing growth in the deposits and other financial assets of households. Those data indicate that households bought more financial assets than may be concluded from the saving rate alone (see Figure B3.2). Furthermore, the rate of growth in deposits in Estonia was one of the fastest in the euro area in 2023 and 2024.

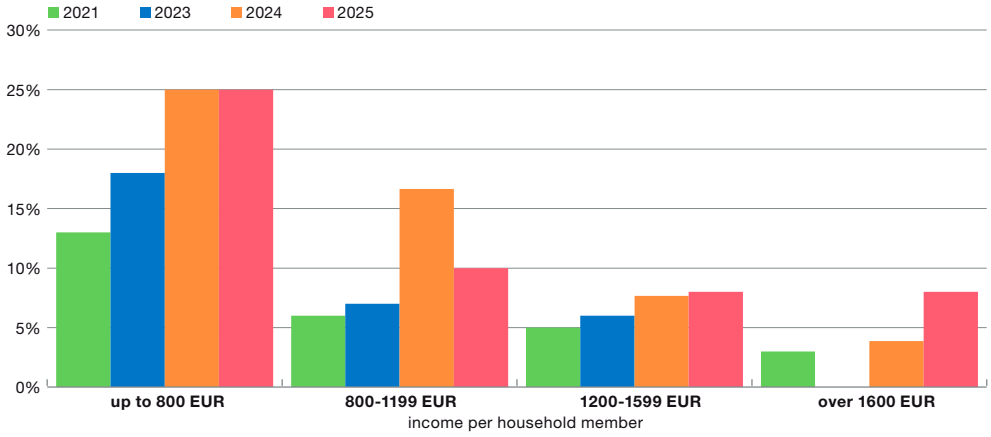
Money that is saved in deposits and other assets is not necessarily going to be used later for consumption. Deposits and financial assets are unequally distributed between households and people with higher incomes or more assets generally spend relatively less of their income than those with average or lower incomes.

The data on the distribution of savings across income groups are not regularly updated. Eesti Pank does however order a survey of the financial behaviour of households each year[20], and one of the questions in that concerns the capacity to save. The answer to that question can be combined with the data on income submitted by the respondents.

The share of people who say they have no money at all left after essential spending and loan repayments has increased in recent years across all income groups. At the same time the share

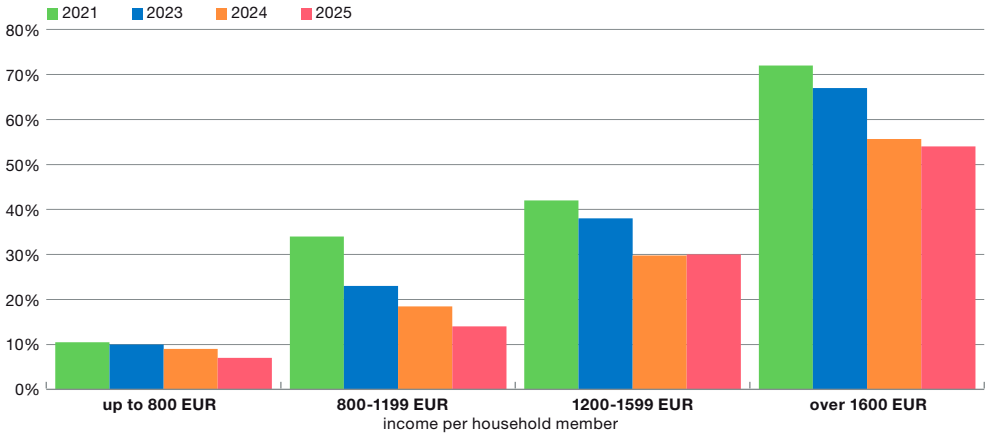
20 Survey of the financial behaviour of Estonian residents.

Figure B3.3. Share of respondents in the survey of financial behaviour with no excess savings after essential spending by income group



Source: Eesti Pank

Figure B3.4. Share of respondents in the survey of financial behaviour with savings of over 500 euros after essential spending by income group



Source: Eesti Pank

of households that have more than 500 euros per household member left after essential spending and loan payments has decreased, and has done so in all income groups (see Figures B3.3 and B3.4).

Households with higher incomes have more money left over after essential spending, but the share of even such households with money to spare has shrunk over the past three years. This coincides with the time when rising interest expenses were taking an increasing share of the disposable income of households, at least those with a housing loan, restricting their ability to consume and save.

The survey of financial behaviour ordered by Eesti Pank finds that the share of households that have housing loans is highest in the age group 30-44, and it is this age group that has the highest marginal propensity to consume. People aged under 30 or aged 50 and older have a smaller marginal propensity to consume[21], though wages are also highest for workers in their 30s and 40s[22].

21 The Household Finance and Consumption Survey HFCS 2021.

22 Group PA636 in the data of Statistics Estonia on the average gross hourly wage of workers working full and part-time.

Higher interest rates consequently reduced disposable income most for the age group that earns relatively more and spends a larger part of its income on consumption. It was also the 30-44 age group where those who thought higher interest rates and larger loan payments were an economic problem were more prevalent[23]. High inflation broadly affected everybody, and even had more impact on people and households with lower incomes[24], but rising loan costs had most impact in the part of the income distribution that also consumes the most.

The saving rate rose in 2024 and was boosted by a rise in household incomes at the end of the year. The rise in income tax at the start of 2025 led companies to pay out more in dividends and to increase their spending on pay by bringing wage payments forwards to the end of 2024. The result was that the financial account transactions of private individuals were over a billion euros larger than a year earlier. Business wealth is relatively unevenly distributed as the majority of it is held by the wealthiest 20%[25], and the jump in the stock of deposits at the end of the year was particularly notable within the band of larger deposits, as the stock of deposits of over 50,000 euros provided more than 80% of the total growth in deposits at that time[26]. This means though that the additional income went mainly to those households that have a smaller marginal propensity to consume.

The saving rate is likely to be lower in 2025 as income tax rose at the start of the year and the rise in consumption taxes also pushed inflation up. Growth in disposable income in 2026 will however lift both consumption and saving further. The effect of changes to the income tax system will give households some 700 million euros of additional income over the year. A large part of that additional income will go to the deciles with higher incomes, whose marginal propensity to consume is smaller, and who will use that money to increase their savings.

23 Survey of the financial behaviour of Estonian residents ordered by Eesti Pank, 2024.

24 See also Box 2, *Differences in inflation across income groups*, RPM 2/2022.

25 Jaanika Meriküll and Tairi Rõõm. *What can explain wealth inequality in Estonia?* Working Papers of Eesti Pank 2/2023.

26 Data on deposits from the Guarantee Fund, which also cover deposits of non-residents in Estonia. The contribution of large deposits of over 50,000 euros to growth in total deposits was larger in 2024 at around 80% than in 2023, when it was around 70%.

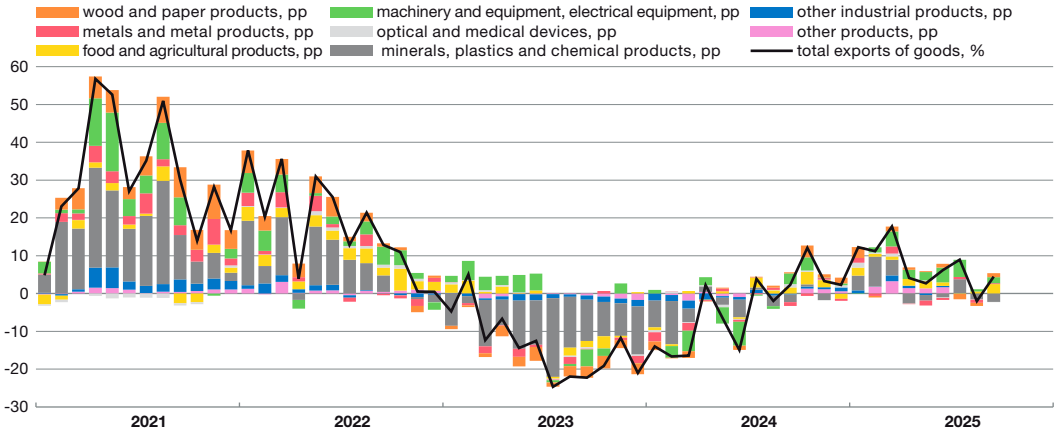
EXTERNAL BALANCE AND COMPETITIVENESS

Global trade rebounded in 2025 and this also increased demand from Estonia's trading partners. Exports of goods from Estonia started to recover last year, and they continued to do so this year. Foreign trade volumes were larger in the third quarter than a year earlier. The short-term outlook for exports is good, mainly because of demand improving and because the uncertainty that came from the introduction of protectionist tariffs has faded. The amount of goods and services exported was up by 5.7% in the third quarter, while imports were up by 5.6%.

Goods exports increased as foreign demand improved. The volume of goods exported increased by 4% in the third quarter, which was a faster rate than in the second quarter. The turnover of exports to Sweden increased among major trading partners as the economy there revived, but the Finnish economy remains depressed. There was again significant growth in exports to central Europe, Poland and Lithuania, while exports to Germany also grew. These markets have compensated for the decline in exports to the Nordic countries. The groups of goods that made the biggest contribution to the growth in the turnover of exports were machinery and equipment, wood and wood products, and processed food products (see Figure 22).

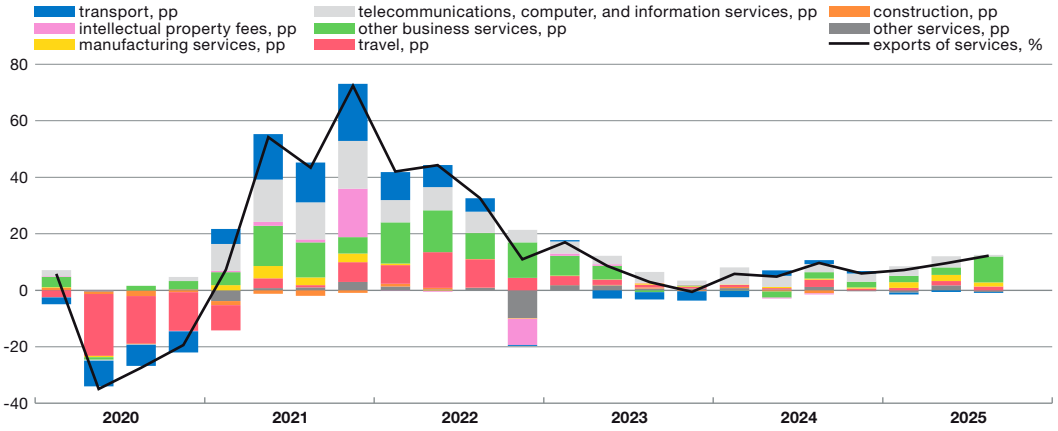
The recovery of manufacturing and the economy as a whole increased the need for inputs and raw materials and so boosted imports, and the volume of imports of goods was consequently 3.6% more than a year earlier. The biggest contributors to the growth were imports of machinery and equipment and of electronics. Goods imports were also affected during the year by one-off purchases of capital goods for national defence. Services

Figure 22. Exports of goods and contributions of groups of goods



Source: Statistics Estonia

Figure 23. Exports of services and contributions of groups of services

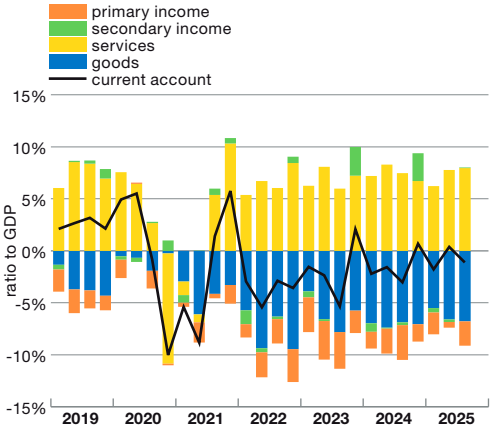


Source: Eesti Pank

imports also grew in volume at the same time, and were 9.7% larger over the year.

Stable growth in exports of services continues to give support to the external balance. The turnover of services exported increased by 12% in the third quarter and the volume increased by 8%. This growth was led by business services, where the turnover of exports increased by 34%, while exports of telecommunications and computer services increased by 3%. The turnover of exports of travel services increased by 8% during the spring and summer tourism season but exports of transport services declined throughout the year and continued to do so in the third quarter, largely because of a drop in road transport of goods (see Figure 23).

Figure 24. Current account



Sources: Statistics Estonia, Eesti Pank

The balance of payments showed the current account was 117 million euros in deficit in the third quarter of 2025, or 1.1% of GDP. The current account improved because the deficit on the goods account was smaller than it was a year earlier, while the surplus on the services account was larger than a year earlier (see Figure 24).

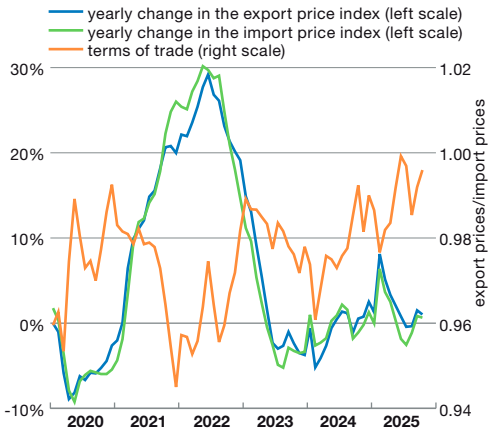
Terms of trade have generally improved in 2025 for the exporting sector as a whole and for manufacturing. Export prices rose faster than import prices in the first half of the year, but the growth in both export and import prices has been at the same level since the end of summer (see Figure 25). Developments in terms of trade have consequently not been a barrier to competitiveness.

Assessments by companies of the state of their export orders improved further in the second half of the year, and are slowly moving in a positive direction. Equally though there was a notable change in how companies estimated their own competitiveness, as there was some improvement in the outlook within Europe but a small retreat from the first half of the year in markets outside the European Union (see Figure 26).

THE LABOUR MARKET

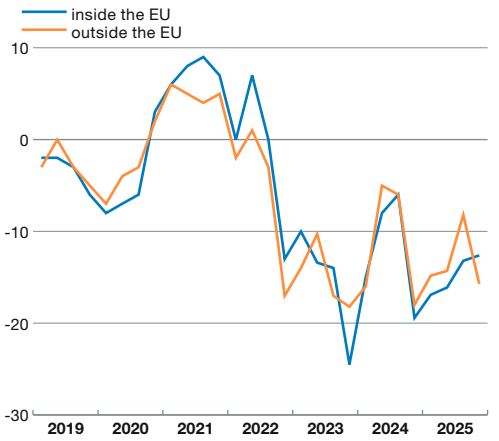
The labour market was in a better place in the third quarter of 2025 than it was in the first half of the year. The labour force survey shows that the number of people in employment was extraordinarily high, though the quarterly point estimates in that survey have been quite volatile. The survey reported employment to be unexpectedly low and unemployment high at the start of the year, but then showed the position to be unexpectedly strong in the third quarter. The confidence bounds of these estimates are quite wide, and so the volatility may be a consequence of the statistical imprecision arising from the sampling in the survey. The comprehensive registry data of the Tax and Customs Board show that the number of people declared as receiving a wage under an employment contract was 0.4% lower than a year earlier throughout the first 10 months of 2025, except January when there were extraordinarily few wages paid out because they had been time-shifted[27]. The number of people receiving a wage was the same in the second quarter as in the first, but it started to fall little in the third quarter (see Figure 27).

Figure 25. Export and import price indexes



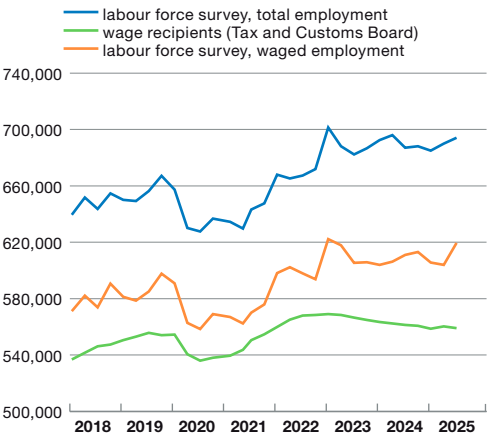
Sources: Statistics Estonia, Eesti Pank calculations

Figure 26. Assessment by businesses of their competitiveness in foreign markets



Source: European Commission

Figure 27. Employment at Estonian companies and institutions, seasonally adjusted



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

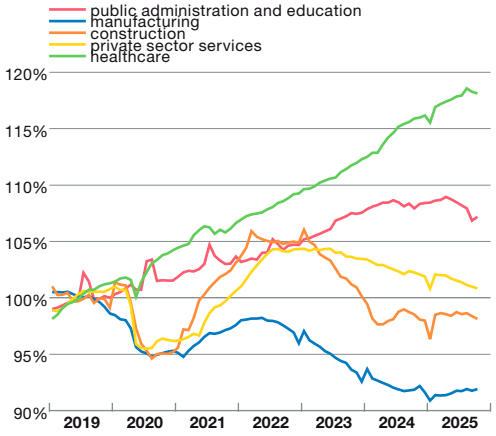
27 The rise in income tax in 2025 caused some wage payments to be shifted backwards into 2024 and so there was a dip in January 2025 in the number of people receiving wage payments.

Register data show employment falling in the private sector and growing in the government sector. The data show that there were 0.7% fewer people receiving a declared wage in the private sector in the first 10 months of 2025 than there were a year earlier, but without the outlier of January there were 0.5% fewer. Employment held relatively stable over the summer in monthly comparison, but it started to decline a little more in the autumn months. The number of people receiving a wage in the government sector was 0.3% higher than a year before in the first 10 months of the year in total, and 0.2% higher in the third quarter. Changes in the core activities of institutions mean that public administration and education can no longer be distinguished, but employment in those two areas together fell in the third quarter, while the number of employees in healthcare continued to rise. The number receiving a wage in private sector manufacturing has increased throughout 2025 and the number in construction has remained stable, which represents a substantial turn for the better after a long period of decline. Employment in services overall continued to decline though as there were 1% fewer people working in the sector throughout February to October than a year earlier. The biggest fall was in retail, while the number of people working in information and communications, administration and support services, and transportation and storage was also down (see Figure 28).

The employment expectations of companies in the fourth quarter have returned to their long-term averages across sectors. The exception is retail, where expectations remained below average (see Figure 29). Expectations for employment in manufacturing and construction are in line with actual changes in employment, suggesting that the improvement will not prove temporary. There is not yet any clear sign of the number of jobs intermediated by Töötukassa starting to rise. There were 1.7% more vacancies in the first nine months of the year than a year earlier, but in the third quarter there were 3% fewer. The picture is better in manufacturing as there were on average 15% more vacancies than a year earlier, while there were 3% fewer in construction.

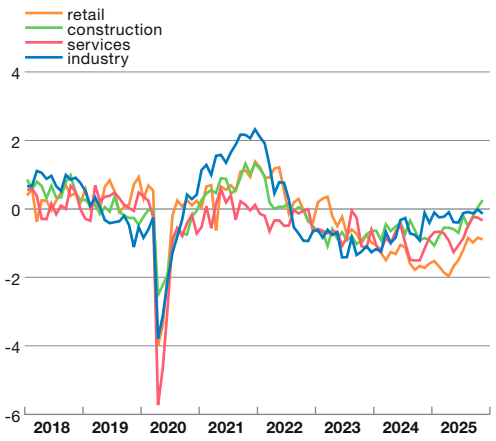
The unemployment rate continued to fall in the third quarter of 2025, dropping to 7.1% from 7.8% in the second quarter. The three-month average unemployment rate in August, September and October, which is an indicator that prefigures the fourth quarter, remained at the level of the third quarter. Seasonally adjusted unemployment has also been down across the year, falling from 8.3% in the first quarter to 7.5% in the third. Although the unemployment rate is lower than the extraordinarily high peak it reached at the start of the year, it is still around a percentage point above the natural unemployment rate or NAWRU[28]. While the estimate of unemployment based on surveys increased at the start of the year, the number registered as unemployed has been trending downward since the end of 2023 and fell by a total of around 8000 people (see Figure 30).

Figure 28. Declared wage recipients seasonally adjusted, 2019 = 100%



Sources: Tax and Customs Board, Eesti Pank calculations

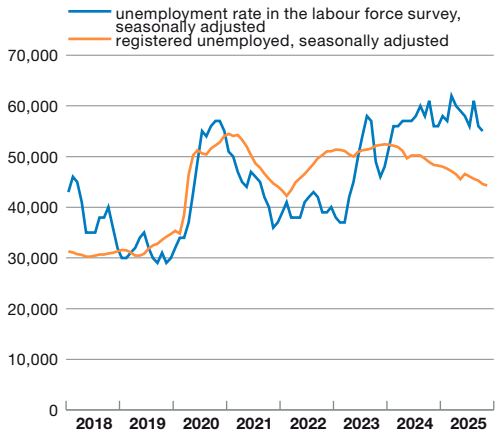
Figure 29. Employment expectations, standardised



Sources: European Commission, Eesti Pank calculations

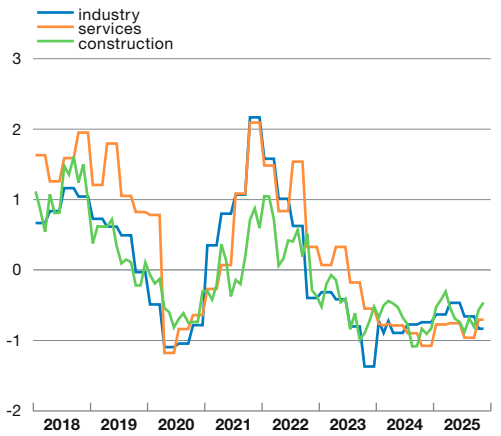
28 The non-accelerating wage rate of unemployment (NAWRU) is the level of unemployment where labour shortages in the labour market do not put upwards pressure on wages.

Figure 30. Unemployment



Sources: Statistics Estonia, Töötukassa, Eesti Pank

Figure 31. Labour shortages, standardised



Sources: European Commission, Eesti Pank calculations

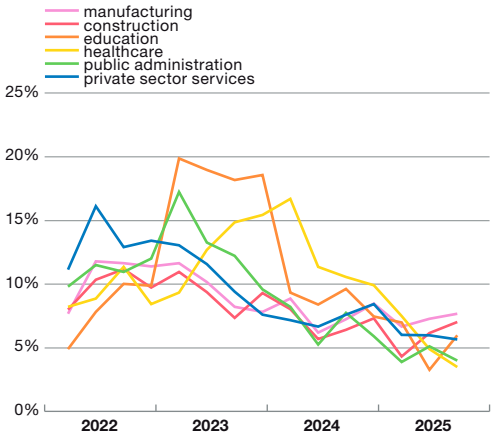
The share of employers who consider labour shortages to be the most important barrier they face remained below its historical average level in the third and fourth quarters (see Figure 31). This is because there is more labour available in the labour market than usual, and it is easier for companies to find new employees. It may also be because a lot of companies have not yet started to hire additional workers. Wage pressures arising from labour shortages should consequently remain weaker than the average.

The average wage was 5.9% higher than a year earlier in the third quarter of 2025, which was the same rate of increase as in the second quarter. The average gross monthly wage was 2075 euros in the third quarter. Lower wages rose the most over the year and the median wage increased by 6.3%, meaning there is less wage inequality than there was last year.

Wage growth in the public sector will be below that in the private sector this year, as the wage rises agreed collectively in healthcare and education were small. Private sector wages in manufacturing have been growing faster than the national average for several quarters now, which is in line with an improvement in the sector though it could indicate that hiring of new employees could run into some tightness in the labour supply (see Figure 32).

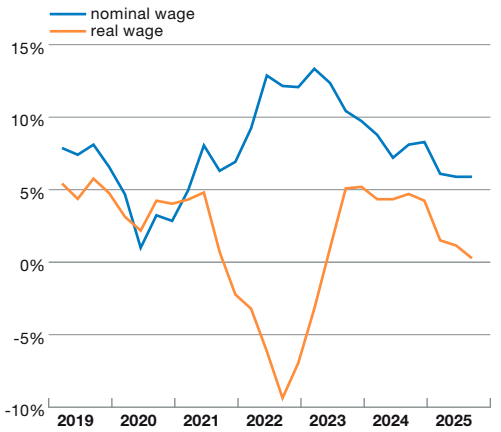
Consumer price inflation increased to 5.6% in the third quarter and so real gross monthly wages were at about the same level as a year earlier (see Figure 33). The rise of two percentage

Figure 32. Yearly change in average wages



Sources: Statistics Estonia, Eesti Pank

Figure 33. Yearly change in average wages*

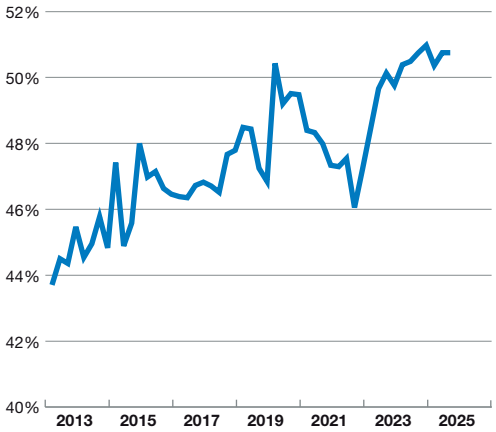


* Structural break in 2022; series for 2019-2021 adjusted by Eesti Pank
Sources: Statistics Estonia, Eesti Pank

points in income tax meant though that net wages had less purchasing power than a year earlier.

The national accounts show that the total payroll in the economy grew by 4% in the third quarter of 2025, which was the same amount as GDP at current prices. The estimate for growth in the payroll is more modest than might be expected from the developments of wages and employment. The payroll has in broad terms remained stable as a share of GDP over the past year (see Figure 34). Labour costs tend to increase as a share of value added during a recession as companies prefer to hold on to their employees even during more difficult times so that they are better able to increase production rapidly when demand revives. This picture is reversed as the economy recovers, as other components of GDP grow first while the share of labour costs only starts to increase later.

Figure 34. The labour share in GDP, seasonally adjusted



Sources: Statistics Estonia, Eesti Pank calculations

Box 4: Trends in the mismatch between vacancies and unemployment in the Estonian labour market

The creation of new employment relationships has been researched a great deal in labour economics and one of the most important treatments of it is the search and matching theory of Diamond, Mortensen and Pissarides. The centre of this theory is the matching function in which the creation of new matches or hires depends on the numbers of positions vacant and people unemployed in the labour market. The features of the matching process are efficiency, which shows how many new matches can be created for a given number of vacancies and unemployed people, and elasticity, which shows how sensitively the number of new matches reacts to changes in those figures.

In reality, the labour market is frequently much more fragmented than this would suggest, as people mostly look for work that is close to where they live and that matches their experience and skills. Some of the possible new matches do not materialise in practice, as the distribution of the skills among jobseekers does not entirely meet the needs of employers and does not entirely overlap with the location of vacancies.

This box analyses the mismatch between jobseekers and vacancies. It uses data from Töötukassa on registered unemployment and vacancies from 2016 to September 2025 and the methodology of Şahin et al. (2014)[29], which has been applied in Estonia by Ferraro and Kommer (2023)[30] for data from 2011 to January 2021.

Şahin et al. (2014) developed an index to measure the extent of mismatches and analyse trends by comparing the actual number of new hires with the theoretical maximum there could be. The theoretical maximum shows the largest possible number of hires that could be created for a given number of vacancies and people unemployed if all jobseekers could be freely distributed across the different segments of the labour market with no cost.

29 Şahin, A., Song, J., Topa, G., & Violante, G.L. (2014). *Mismatch unemployment.* American Economic Review, 104(11), 3529–3564. https://doi.org/10.1257/aer.104.11.3529.

30 Ferraro, S., & Kommer, P. (2023). *Is there a labour market mismatch in Estonia? Measuring regional, occupational and industrial labour market mismatch.* Baltic Journal of Economics, 23(2), 200–228. https://doi.org/10.1080/1406099X.2023.2275865.

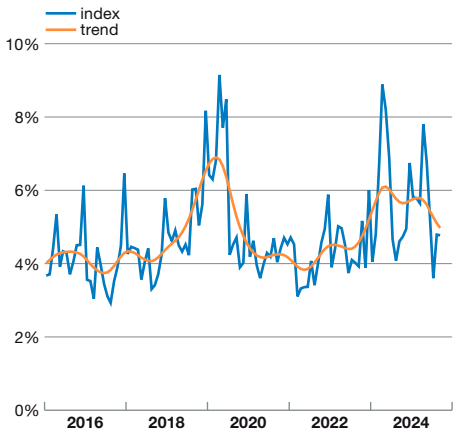
Intuitively, the mismatch is smaller when the distributions of jobseekers and vacant jobs across segments of the labour market are more similar, meaning the correlation of those distributions is greater. The mismatch would be greater for example if most of the people unemployed were on the western island of Hiiumaa while most of the jobs available were in the very south in Võrumaa. Matching is affected not only by the distribution, but also by the efficiency within segments of the labour market, as different segments may not create the same number of matches even if the numbers of people unemployed and vacancies are the same. Maximising new hires at the national level then requires a large part of the jobseekers to be in or to move into segments where matching is more efficient. The mismatching index does not show directly how easy or difficult it is to hire new employees within the economy.

Given the availability of data, this analysis has followed Ferraro and Kommer (2023) by calculating a mismatch index that assumes the segments of the labour market are region, sector and profession. This is a simplification because people can take jobs outside the region where they live, move from the sector where they used to work into a different sector, or change profession. The actual segmentation could though be even greater, as it may not be realistic for all jobseekers to consider positions that are not in their own town or that are beyond a certain distance from home.

Figures B4.1-B4.3 show estimates of the mismatch index. The calculations show that the mismatch is greatest in the sectoral dimension and then by profession, and smallest in the regional dimension. This means that the best way to help jobseekers find work is to widen their search across different sectors.

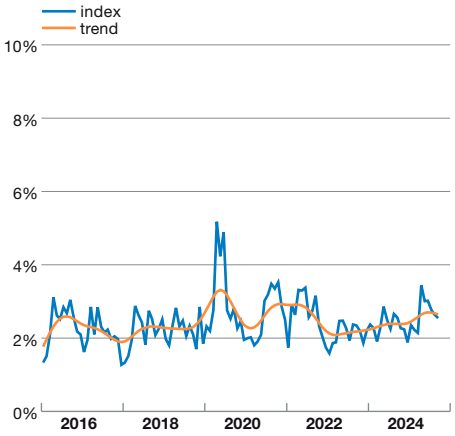
The pandemic made matching worse across all the dimensions observed, as might be expected, because it did not affect all the different segments of the economy equally. This effect was temporary though, as demand for labour increased rapidly and sharply after the pandemic. The indicator for calculating mismatches also shows that there was a

Figure B4.1. Mismatch index by sector



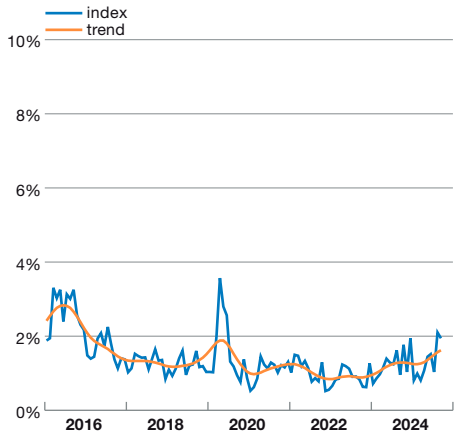
Sources: Töötukassa, Eesti Pank

Figure B4.2. Mismatch index by profession



Sources: Töötukassa, Eesti Pank

Figure B4.3. Mismatch index by region



Sources: Töötukassa, Eesti Pank

deterioration in matching from the second half of 2023, indicating that the distribution of the previous jobs held by people now unemployed had become less similar to the distribution of vacancies. This probably reflects changes caused by the long recession that were felt in different sectors to different extents. The matching function in manufacturing became less efficient at this point though, indicating that the increase in mismatches may not only have come from the cyclical fluctuations.

Elasticity in the matching function calculated from the data for the whole economy decreased in the period observed. This means that the increase in the number of new employment relationships relative to the increase in the number of vacancies is smaller than before. If this trend continues then employment will rise more slowly than in earlier years as the demand for labour increases.

Some limitations should be borne in mind when interpreting this analysis. New hires across the whole of the economy and all regions means the number of people registered as unemployed who leave the Töötukassa register to take up a job. It is not compulsory to advertise vacancies through Töötukassa though, and so some people find work through other channels, meaning that comparing the hiring rate to the vacancies advertised by Töötukassa may produce an overestimation.

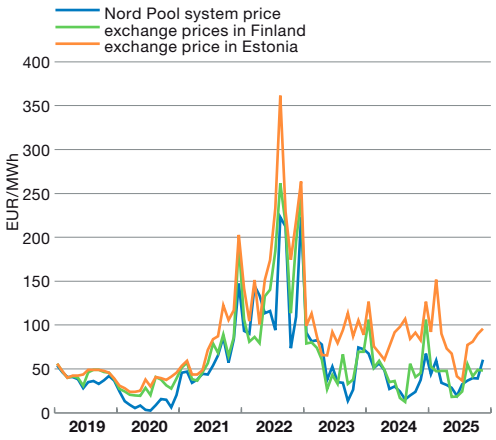
There are no direct statistics on hiring by sector and profession, and so the outflow of vacancies is used to give an approximation of the distribution there. There are two notable drawbacks to this measure, as it may underestimate hiring because some employment relationships are created without Töötukassa, and it may equally overestimate hiring because job advertisements expire in Töötukassa after 30 days and if they are reposted after more than two weeks they are counted as new vacancies.

PRICES

Inflation continued to fall in the fourth quarter. It was above 6% in August but had come down to 4.9% by November. New price pressures in the second half of the year came mainly from tax rises because VAT rose in July as did excises on alcohol and tobacco. Without the impact of tax rises, price pressures weakened and inflation over the year has fallen to close to 2%.

Energy prices have been falling throughout the year and prices for motor fuels and electricity are lower than a year earlier. Petrol station chains started to cut prices one after another in September, and petrol prices remained at the lower level in October. The price war in the fuel market cut half a percentage point off overall inflation in the consumer basket, though fuel prices started to rise again in early November. The price of electricity also started to rise in November (see Figure 35).

Figure 35. Electricity exchange prices



Source: Nord Pool

Manufactured goods have also helped rein in inflation of late. Movements in the prices of consumer goods sold in Estonia are usually strongly correlated with those in prices in the euro area, though prices for clothing and footwear have this year fallen even faster than those in other euro area countries. Inflation for manufactured goods has been held down of late by the appreciation of the euro, which has particularly pulled down the prices of goods imported from outside Europe.

Inflation for food products picked up in the third quarter. Prices fell back though for almost

all groups of goods in the fourth quarter (see Figure 36), which was to some extent the usual seasonal move, particularly for fruit and vegetables. A further reason was that price pressures for food commodities weakened throughout the year, though the effect of this passes into consumer prices with a long lag.

Service price inflation is being buoyed this year by rises at the start of the year in several administered prices. The introduction of the vehicle tax and the rise in the price of medical services had the biggest impact. Prices for air tickets, package holidays and hotels have been very volatile as they are driven by seasonal demand and promotional campaigns.

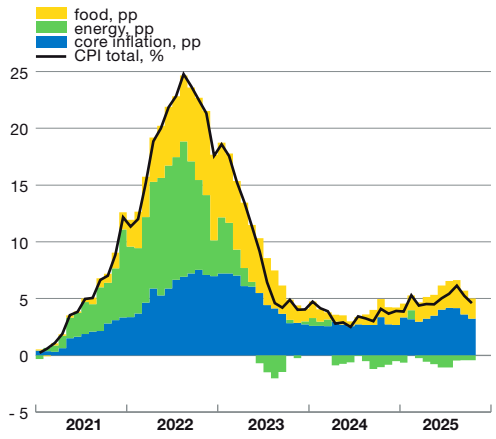
GENERAL GOVERNMENT FINANCING

Strong growth in wages meant that growth also remained strong in receipts of labour taxes in the third quarter. The aggregate yearly growth in tax revenues slowed in the third quarter nonetheless (see Figure 37). Tax revenues received in the state budget were 7.8% up on the year, but the growth in them was restrained particularly by substantially less corporate income tax being received in July than a year earlier. Receipts of corporate income tax were boosted sharply last July by the tax paid on dividends distributed by credit institutions, but profits were not distributed to nearly the same extent this year.

There was a notable setback to receipts of VAT at the start of the third quarter. Consumption was shifted forward in anticipation of the rise in the standard rate of VAT from 1 July, and so yearly growth in the receipts of VAT was smaller in July and August than in May and June. The increase in VAT receipts last year was smaller than the rise in the tax rate itself, but in the third quarter of this year the increase in VAT receipts was larger than that in the tax rate. One reason for this may have been strong growth in inventories. Receipts from VAT increased even further in October, and they were 11.0% up on the year in the third quarter and 16.8% up on the year in October.

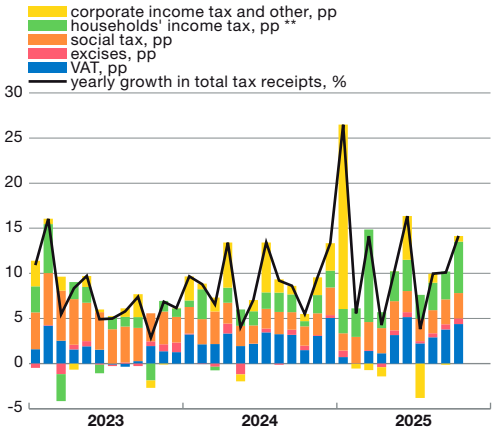
Preliminary data show that aggregate growth over the year in the main components of general government expenditures such as the payroll, social benefits paid in cash, investment, and intermediate consumption was smaller in the third quarter than in the first two. The data currently available show that the yearly growth in the money paid out as social transfers continued to slow substantially. This was mainly because indexing of pensions on 1 April meant the growth in them was smaller than in the previous year. A fall in the number of births also reduced the amount paid out in child support and family benefits. Data from Statistics Estonia show that the yearly growth in the general government payroll was a little faster in the third quarter at 4.9% than it was in the second quarter. The average wage in the government sector rose at more or less the same rate as in the second quarter, and this rate remained slower than that in the private sector.

Figure 36. CPI growth



Sources: Statistics Estonia, Eesti Pank

Figure 37. Tax revenues in the state budget*



* Accrual accounting
** Including PIT transferred to local governments
Sources: Statistics Estonia, Tax and Customs Board

Yearly growth in general government investment slowed in the third quarter to 12.3%, having been more than 25% in the first quarter and 19.2% in the second. Growth was driven above all in the third quarter by general government spending on investment in construction, which started to increase again after a year of decline, and gained 10.6% over the year. Investment in other machinery and defence equipment also continued to increase, though at a slower rate than in the previous quarter. Accounting data from entities in the general government sector show that the economic affairs function that includes for example expenditure related to transport was the one that contributed most to the growth in acquisition of fixed assets in the third quarter.

THE EESTI PANK ECONOMIC FORECAST FOR 2025-2028

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 September 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 INTERNATIONAL ECONOMIC ENVIRONMENT

The global economy

The global economy will continue to grow at a moderate rate. The latest forecast by the International Monetary Fund (IMF) expects the global economy to grow by 3.2% in 2025 and 3.1% in 2026[31]. This outlook is a slight improvement on the previous one because the tariffs imposed by the USA on imported goods have proved to be lower than was feared and most other countries have refrained from taking countermeasures, while the US has signed new trade treaties with several countries. The result is that there is now less general uncertainty around trade policy. Recent positive economic figures for the larger economies have also helped improve the outlook for growth in the global economy. There are still several risks though that overshadow the global economy. Fiscal stimulus and looser monetary policy in many large countries are supporting economic growth, but geopolitical tensions and the fracturing of international trade continue to make the economic environment difficult. Businesses working with artificial intelligence may also turn out to be less profitable than expected, and that could increase volatility in financial markets and endanger economic stability.

Some countries are supporting growth in their economies through looser financing conditions and fiscal policy support. The IMF expects growth in the US economy to slow to 2.0% in 2025 and then stay at 2.1% in 2026. This is below the 2.8% recorded in 2024 and reflects the political uncertainty, higher trade tariffs and slowing growth in employment, which will be balanced by an expansive fiscal policy, private sector investment in artificial intelligence, and looser monetary policy. The economy in the United Kingdom will grow by around 1.3% this year and next, with support from the strength of the services sector and from falling energy prices. Growth in the economies of emerging markets will slow from 4.2% in 2025 to 4.0% in 2026. The growth will mainly be seen in Asian countries, where strong domestic consumption, investment in the technology sector, and the reorganisation of supply chains will help ease the impact of higher tariffs and the uncertainty around international trade. Weakness in the real estate sector will hold back growth in the Chinese economy to 4.2% despite fiscal policy support and lower production costs.

Global inflation will continue to fall, though inflation will remain persistent in the USA. The IMF forecasts that global inflation will average 4.2% in 2025 and 3.7% in 2026. Inflation in advanced economies will average a little above 2% next year, while in emerging nations it will be 4-5%. Inflation will be higher in the USA because of the tariffs that have been imposed. Monetary policy will gradually be eased, though the decisions of central banks will continue to be affected by factors that are difficult to forecast, such as the volatility of energy prices, changes in trade policy, and increasing debt levels. Price pressures will remain strong in several emerging economies, particularly those where food prices are rising fast and currencies continue to weaken.

The euro area

Growth in the euro area economy has proved resilient despite the uncertainty around trade policy, but the rate of growth will remain modest for the time being. Growth will

31 IMF World Economic Outlook, October 2025.

be supported primarily by the good performance of private consumption and the services sector. The international tariff agreements reached in the autumn reduced global uncertainty a great deal, but the confidence of consumers and businesses in the euro area still suffered a heavy blow. Corporate investment consequently fell despite interest rates coming down a long way. Exports from the euro area were doing well in first half of the year as trading partners stocked up on supplies of goods in fear of higher tariffs being imposed. This proved only temporary though, and weak foreign demand, the appreciation of the euro, and structural problems of competitiveness mean that exports will be weak in the near future. Growth in exports will only pick up towards the end of the forecast horizon, though even then at an insipid rate. Growth in the trade in goods within the European Union and agreements on trade and tariffs being signed will provide some relief to European companies. Investments in artificial intelligence will support the euro area manufacturing sector in the short term, as will public sector investment in the defence industry and infrastructure in Germany and elsewhere. The construction sector in the euro area is also performing better because of increased general government spending and a less tight monetary policy. This will all breathe life into the economy in the euro area. These largely unavoidable expenses will however drive growth in government debt in the euro area even higher than it already is, and so several countries will need to face up to the need for some difficult financial consolidation in the years ahead. Growth in GDP in the euro area will be 1.4% this year, will slow to 1.2% in 2026, and will then rebound to 1.4% in 2027 and 2028.

Inflation will remain close to the target set by the Eurosystem. Energy prices have not fallen as quickly as they did at the start of the year, but the peak of inflation for services has now essentially been passed and the same trend is apparent for food prices. Aggregate inflation will consequently remain quite stable at around 2% moving forwards. Domestic price pressures such as wage growth are also lessening. Inflation in the euro area will be 2.1% this year and will fall to 1.9% in 2026, before accelerating to 2.0% in 2028[32]. Tensions in global trade policy could however push up the prices of commodities and so cause inflation to rise again. Survey data have shown some signs of cooling in the labour market, as job creation has slowed a little, the number of vacancies is falling and wage growth is slowing. Real wages continue to rise though because inflation is lower, and this is supporting consumption by households and so the whole of the economy. The unemployment rate in the euro area will also remain close to a historically low level moving forward.

Estonia's main trading partners

The economies in Estonia's main trading partners are about to start growing faster. Economic growth is forecast in all of Estonia's main export markets for 2026, but the rates of growth still differ quite widely. The recovery in the Swedish economy has picked up again after a temporary setback in the first half of 2025, when the US set high protectionist tariffs on trade with the European Union and other trading partners[33]. Growing real incomes, lower interest expenses, and a supportive tax and fiscal policy should strengthen consumption and overall economic activity from the second half of 2025. The Lithuanian economy continues to grow fast and in the short term will have the fastest growth in the Nordic and Baltic countries. Growth in the Lithuanian economy will continue to be boosted by the good performance of the Polish economy, as Poland is Lithuania's main export partner, and a temporary lift will come from the pension reform that will come into force in 2026. Consumer confidence has started to improve in almost all of Estonia's trading partners, and the main support for economic growth is expected to come from domestic demand. Weak foreign demand will continue to restrain faster growth in exports though. The Finnish economy will continue to perform a little worse than those of other neighbouring countries next year, as the weakness of the construction sector and government spending cuts continue to be obstacles to a stronger recovery. Growth will accelerate strongly towards the end of the forecast horizon though in Finland and Latvia, and mainly with support from private consumption. The Latvian economy will gain additional support from public sector investment, spending on national defence, and funding from the European Union.

The labour markets in Estonia's trading partners will improve and inflation will fall. Inflation in Latvia and Lithuania is still higher than the average in the euro area, but it is forecast to

32 Because of the introduction of ETS2.

33 A larger part of Sweden's trade is with the USA than is the case in several of Estonia's other large trading partners.

fall steeply as the effect of tax changes passes out and inflation for food prices falls. Wages in those countries are also rising less fast, and this will then also reduce domestic price pressures. Purchasing power will improve in all of Estonia's neighbours as incomes grow at a faster rate than inflation, and household budgets get support from falling interest rates. Unemployment will remain high in Sweden and Finland at first, but the labour market will improve as unemployment falls. Employment is also expected to grow faster in 2026.

TECHNICAL ASSUMPTIONS USED IN THE FORECAST

Assumptions for the external economy

The outlook for export markets has improved notably. The economies of Estonia's main export markets will grow this year by 3.6%, which is 1.2 percentage points faster than in the previous forecast. Growth in foreign demand in 2026 will also exceed earlier expectations by 0.9 percentage point (see Table 2). Growth in foreign demand will be around 3% in 2027 and 2028, which is the average rate of the past decade.

Cheaper energy and an expected fall in food commodity prices will bring inflation down and support the economy. Futures transactions show the oil price is expected to fall to 62.6 dollars a barrel in 2027, which is around 10% cheaper than this year. The impact of cheaper oil on local fuel prices will be weaker than was expected earlier because the exchange rate of the dollar will be a little stronger.

The outlook for interest rates remains essentially unchanged. The expectations for interest rates found from future transactions in the money markets are essentially unchanged from the September forecast, with the three-month Euribor at 2.0% next year, which is 0.1 percentage point higher than was assumed in the previous forecast. The three-month Euribor will be 0.2 percentage point higher than previously expected in 2027 at 2.1% (see Table 2). Interest rates have consequently stopped falling but the full impact of the lower rates has not yet reached the economy. The effect of cuts in interest rates is felt faster by borrowers in Estonia than by those in other countries in the euro area because a much larger share of loans in Estonia are linked to short-term interest rates.

Assumptions for general government financing

The assumptions for tax policy in this forecast take account of all the tax changes that have been passed. These cover the motor vehicle tax that came into force this year, the rise in personal and corporate income tax rates to 22%, and the change to the income tax system that will apply from 2026. The Eesti Pank December forecast differs from the September forecast because it now also allows that the rate of personal and corporate income tax will not rise to 24% next year.

The forecast for investment, intermediate consumption, and non-tax revenues in the state finances uses the assumptions for revenues and expenditures in the state budget strategy 2026-2029 (see Table 3), but also adjusts the forecast receipts of non-tax revenues in 2025 slightly upwards from the budget strategy to reflect the statistics already published. Using the assumptions for expenditures from the state budget strategy means that the forecast takes account of the increase in spending on national defence to above 5% of GDP.

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

					September 2025 projection		
	2025	**2026**	**2027**	**2028**	**2025**	**2026**	**2027**
Foreign demand growth (%) [2)]	3.6	3.0	2.9	3.0	2.4	2.1	2.9
USD/EUR exchange rate	1.128	1.157	1.157	1.157	1.128	1.163	1.163
Interest rate (three-month EURIBOR, %)	2.2	2.0	2.1	2.3	2.2	1.9	2.1
Oil price (USD/barrel)	69.2	62.5	62.6	64.0	69.7	65.1	65.1
Price growth for food commodities (EUR, %) [3)]	4.6	-2.1	2.6	2.0	4.3	-0.3	2.5

1) Cut off date of technical assumptions is 1 December 2025 2) Weighted growth of imports of trading partners 3) Food commodity price index by European Commission Directorate-General for Agriculture and Rural Development (DG AGRI)
Source: European Central Bank

Table 3. Forecast assumptions for government finances

	2025	2026	2027	2028
Government sector GFCF (EUR billion)	2.9	3.6	3.6	3.5
Government sector intermediate consumption (EUR billion)	2.6	3.0	3.1	3.4
Government sector non-tax revenues (EUR billion)	2.6	2.7	2.5	2.7

Sources: Ministry of Finance, Eesti Pank

ECONOMIC GROWTH

Economic growth will pick up further. The main support for the economy in 2026 will come from foreign markets strengthening and a domestic fiscal stimulus that will help push growth in the economy to 3.6%. The government fiscal stimulus will reach the economy through an increase in the purchasing power of households following the income tax changes, and through increased spending by the general government itself. The Estonian economy will return to its long-term trajectory of growth over the next three years and the negative output gap will close. Short-term growth factors like the fiscal stimulus and the return to use of production resources that were standing idle during the earlier crises will expire, and then the economy will gradually approach its long-term sustainable level of growth (see Box 5 on the impact of fiscal policy on economic growth, and Box 6 on expected long-term growth in the economy). The economy will grow by 2.8% in 2027 and 2.5% in 2028 (see key indicators for the forecast in Table 4 and comparison with forecasts by other institutions in Table 5).

The economy recovering during the forecast horizon will improve the conditions in the

Table 4. Economic forecast by key indicators[1)]

	2024	2025	2026	2027	2028
Nominal GDP (EUR billion)	39.83	41.66	44.56	47.18	49.87
GDP volume[2)]	-0.1	0.7	3.6	2.8	2.5
Private consumption expenditures[3)]	0.2	-0.2	3.6	3.3	2.2
Government consumption expenditures	1.8	2.2	3.1	0.4	2.0
Gross fixed capital formation	-6.1	2.1	8.0	3.6	2.1
Exports	-1.5	4.4	2.8	2.8	3.2
Imports	0.2	4.2	4.6	2.7	2.7
Output gap (% of potential GDP)	-4.0	-4.1	-1.6	-0.3	0.3
CPI	3.5	4.9	2.9	2.4	2.8
HICP	3.7	4.9	3.2	2.3	2.7
GDP deflator	3.9	3.8	3.3	3.0	3.1
Unemployment rate (% of the labour force)	7.6	7.6	6.6	6.2	6.0
Employment[4)]	0.2	0.0	0.4	-0.1	0.0
Average gross wage (EUR)	1980	2097	2210	2321	2435
Average gross wage growth	8.1	5.9	5.4	5.0	4.9
Median gross wage (EUR)	1633	1726	1820	1918	2018
Median gross wage	8.8	5.7	5.5	5.4	5.2
GDP per employee	-0.3	0.7	3.1	2.9	2.5
Current account (% of GDP)	-1.2	0.1	-1.7	-1.5	-1.1
Budget balance (% of GDP)	-1.7	-1.3	-4.5	-4.4	-3.9

1) Numbers reported are annual rates of change in per cent, if not noted otherwise, 2) GDP and its components are chain-linked, 3) including NPISH, 4) employment by domestic production units
Sources: Statistics Estonia, Eesti Pank

Table 5. Estonian economic forecasts by other institutions

	GDP real growth, %					CPI inflation, %				
	2024	**2025**	**2026**	**2027**	**2028**	**2024**	**2025**	**2026**	**2027**	**2028**
Eesti Pank	-0.1	0.7	3.6	2.8	2.5	3.5 3.7*	4.9 4.9*	2.9 3.2*	2.4 2.3*	2.8 2.7*
Ministry of Finance	-0.1	0.8	2.5	2.3	2.2	3.5 3.7*	5.4 5.3*	3.5 3.5*	2.4 2.5*	2.3 2.4*
European Commission	-0.1	0.6	2.1	2.0		3.7*	4.8*	2.8*	2.2*	
IMF	-0.1	0.5	1.5	1.8	1.8	3.7*	5.1*	4.3*	3.3*	2.6*
OECD	-0.1	0.7	2.9	2.8		3.7*	5.0*	3.5*	2.3*	
Consensus Economics	-0.3	0.9	2.4	2.7		3.5	5.1	3.3	2.7	
Luminor	-0.1	1.0	2.0	3.0	3.0	3.5	6.0	3.0	2.0	2.0
SEB	-0.1	0.7	2.5	2.8		3.7*	5.2*	3.2*	2.8*	
Swedbank	-0.3	0.6	2.3	2.6		3.5	5.1	3.0	2.5	

* HICP
Sources: Eesti Pank, December forecast, 19.12.2025; MoF, Summer 2025 Forecast, 26.08.2025; European Commission. European Economic Forecast. Autumn 2025, 17.11.2025; IMF, WEO, October 2025, 14.10.2025; OECD, Economic Outlook, Volume 2025 Issue 2, 02.12.2025; Consensus Economics, Eastern Europe Consensus Forecasts, November 2025, 17.11.2025; Luminor forecast, 17.09.2025; SEB, Nordic Outlook, November 2025, 11.11.2025; Swedbank Economic Outlook, 04.11.2025.

labour market. Companies avoided making redundancies during the recession to the same degree that their value added and output declined, and so they will at first be able to increase their production without hiring new employees. Employment will increase by 0.4% in 2026, but will then remain largely unchanged in subsequent years. The improvement in the labour market will mainly be expressed through an increase in the share of the working-age population that is in employment, and by the unemployment rate falling to 6.0% in 2028.

The labour supply will shrink a little in the coming years but will still remain larger than the average of the past decade. The number of people of working age will fall, as migration will not counterbalance the natural demographic decline. The availability of labour in Estonia means there will be less motivation to hire labour from abroad. The labour force participation rate has been very high in international comparison and relative to its own trend. The participation rate and the labour supply will decrease a little over the forecast horizon. This is because younger people are less active in the labour market as compulsory schooling has been extended and limits on the employment of minors have been tightened.

Labour costs as a share of value added created in the economy increased during the recession but will now decline again and the corporate profit share will increase. Wage growth will slow from 5.9% this year to approximately 5% in the next three years, which is in line with what growth will be in labour productivity and prices. The average wage in 2026 will be shaped by pay rises in the government sector and an expected rise in the minimum wage. The change in the income tax system will also encourage employers to shift wage payments from the final month of this year to the new year. The introduction of a single tax-free income rate for everybody in 2026 will however ease some of the pressure on employers from wage costs, as it will benefit the majority of employees financially. The introduction of the Wage Transparency Directive in the middle of 2026 could have a notable impact on wage setting in Estonia, though the extent of it remains unclear. The directive will require employers to publish wage ranges in their job advertisements, and will give employees the right to know the average wage paid for similar work in the company that they work for.

Private consumption in 2026 will be defined very much by the introduction of the single tax-free income allowance, which will give a total of around 700 million euros to households. This will be a permanent rise in incomes, and so it is reasonable to assume that a larger part of this will be directed to consumption than is the case for one-off increases in income (see Box 7 on the impact of the income tax changes). The improvement in recent months in consumer confidence from the low level it was at for a long time probably also indicates that households have identified the coming impact of the tax changes

on their incomes and purchasing power. Private consumption will consequently increase in volume by 3.5% in 2026. Growth in consumption will then slow and will be 3.1% in 2027 and 2.1% in 2028.

Interest rates and access to bank loans will continue to favour borrowers. Market participants expect that Euribor, which sets the price of loans, will continue to fall until summer 2026, but interest rates have already fallen a long way and any further loosening will only be small. Access to credit will improve because the supply of credit from the banks is good, they have ambitions to grow, and they are of different sizes and have different focuses. The interest margin on housing loans in Estonia has fallen to close to the average in the euro area, and will probably hold steady at that level for some time. The interest margin on corporate loans is high in Estonia in international comparison, but whether it comes down will depend on whether competition pressures pass through from other lending conditions into the interest margin.

Cheaper loans than before, improvements in domestic and foreign demand, and the need to be competitive internationally will increase corporate investment. The lowest point has been passed in most sectors and companies will have to expand their production capital to meet increasing demand. Structural changes in the economy such as an increase in services as a share of it and the reorientation to new markets will require investment in new areas and solutions. There will however be several obstacles to stronger growth in investment, such as the continuing uncertainty about geopolitical developments and local tax policy, and the relatively large amount of production facilities purchased earlier that remain unused, while expectations that economic growth will be slower than in earlier decades will reduce expectations of the profitability of investment in Estonia. Survey data show a reduction in the share of companies planning to expand production in the coming years, while there is increasing interest in upgrading, expanding or replacing existing production capacity[34]. This may, though may not, mean expenditures on capital goods will be smaller.

Improved foreign demand will support growth in exports throughout the forecast horizon. Exports of goods will continue to recover broadly in 2026 and will get support from foreign demand recovering. Increased demand is expected in the Swedish and Norwegian markets, while the Finnish market will still be struggling in the shorter term. Growth in exports of services will remain stable, and will be helped by the good competitive position of Estonian service providers and strong demand for ICT and business services. Companies estimate that their export orders have improved and that they have become somewhat more competitive. The reduced uncertainty about protectionist tariffs will play an important role in allowing foreign trade to revive gradually. Exports from Estonia will grow by around 3% a year over the next three years.

34 https://www.eib.org/en/publications/20240238-econ-eibis-2024-estonia.

Box 5: The impact of fiscal policy on economic growth

Government fiscal policy is one of the many factors that shape growth in the economy and the dynamics of it, as increases or decreases in taxes, government spending and investment can boost or restrain growth in the economy. This box assesses how the general government fiscal policy has contributed to growth in the Estonian economy over the past decade.

It estimates the impact of fiscal policy by first removing the cyclical component of the budget balance and interest payments to give the structural primary balance, and the change in this from year to year then shows the annual fiscal impulse, whose effect on economic growth is then analysed. A negative change in the structural primary balance, meaning a deterioration in it, means fiscal policy has been loosened and so a growth-supporting impulse has been given, while a positive change indicates that fiscal policy has been tightened and a negative impulse has been given to the economy.

How strongly the fiscal stimulus affects growth in the economy depends on the size of the fiscal multiplier. The fiscal multiplier shows how much aggregate output in the economy changes in

response to a one-unit fiscal policy impulse. The literature has found that the size of the fiscal multiplier depends very much on the cyclical position of the economy, as the impact is generally larger during a recession and smaller when the economy is heating up. The output gap[35] is consequently used to distinguish three economic states, which are recession, a normal or neutral state, and an expansionary phase. The size of the fiscal multiplier additionally depends on the degree of openness of the economy among other factors, since fiscal stimuluses have less impact on more open economies, and on the monetary policy environment.

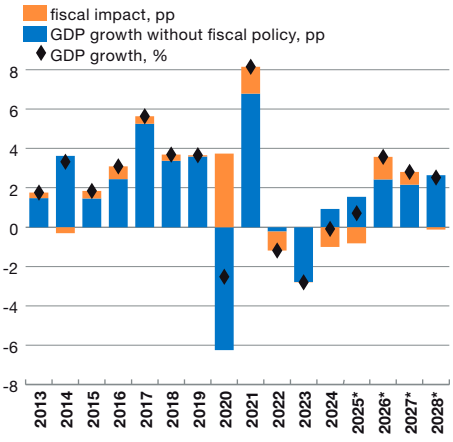
Technical guidelines from the IMF[36] offer rules of thumb that can be used to identify broadly appropriate fiscal multipliers for individual countries. These suggest that Estonia falls into the group of countries with medium and high multipliers, with a multiplier of 0.7 under normal economic circumstances, 1.1 in a recession, and 0.4 when the economy is overheating. These multipliers fit well with the findings in the academic literature.

The multipliers suggested by the IMF have been adapted for this analysis to account for various important factors. The zero lower bound of monetary policy interest rates in 2014–2022 made fiscal policy more effective and so increased the multiplier, while the estimate of the multiplier needs to be reduced in the years when fiscal policy was mainly shaped by tax changes. A particular feature of increased spending on national defence has also been considered since 2023, which is that spending on defence is heavily import-based, and so only part of the impact passes into the Estonian economy, and this analysis assumes that 40% of investment and intermediate consumption for defence may be counted as internal demand within Estonia.

Empirical research has shown that the impact of a change in fiscal policy on the economy generally peaks 4-6 quarters after it happens. The impact on the economy is consequently not limited to only a single year. This analysis assumes that two thirds of the impact of a fiscal stimulus is felt in the year the fiscal policy changes, and one third passes through into the next year. Fiscal policy changes take a long time to pass through because households and companies do not immediately change their behaviour entirely. Part of the additional income that results from a reduction in the tax burden for example appears in consumption in the year the change is made, but the rest of the effect is only felt later when households have adapted their consumption habits and companies have adjusted their strategies.

Fiscal policy over the past six years has affected growth in Estonian economy notably more than it did on average in the preceding decade (see Figure B5.1). It is particularly noticeable how fiscal policy played its classical stabilising role in 2020 of absorbing the sharp and short-term shock to the economy and helping prevent a much deeper recession. As the impact of fiscal policy is not limited to one single year though, some of the large fiscal stimulus from 2020 was passed through into 2021, when the economy was already recovering.

Figure B5.1. Contribution of fiscal policy to GDP growth



* years of the forecast
Sources: Statistics Estonia, Eesti Pank

35 The output gap shows whether the economy is running at above or below its long-term trend for GDP or its potential GDP level. An HP-filtered output gap is used here, which is the deviation of actual real GDP from the statistical trend for GDP, with a Hodrick–Prescott filter applied to the trend.

36 Batini et al. 2014. *Fiscal Multipliers: Size Determinants, and Use in Macroeconomic Projections*. IMF Technical Notes and Manuals.

Fiscal policy then restrained the earlier recovery in the economy in 2024 and 2025 as the tax rises passed to reduce the budget deficit weighed on domestic demand. Without the negative effect of fiscal policy, the Estonian economy would have grown last year and this year at a rate that is broadly in line with the average rate in Finland, Latvia and Lithuania[37] in the same years. This timing of the recovery driven by market forces is also broadly consistent with the revival of exports and manufacturing output from the first half of 2024, but this revival has not yet been evident in the figures for GDP.

Fiscal policy is expected to give a substantial boost in 2026 to economic growth that is already accelerating, and so account for around one third of the growth expected in the economy next year. This will come mainly from the reform of the income tax system that will increase incomes for a large number of wage earners and so increase domestic demand. Economic growth will also be supported by the rapid growth in wages planned in certain areas of the general government. At the same time, these measures together with rising defence spending will widen the budget deficit substantially. The decisions about reducing the budget deficit have not yet been taken, but fiscal consolidation in the future will be unavoidable and the impact of it may again be to restrain economic growth. The impact of fiscal policy on economic growth under the fiscal policy outlook that is currently known will fade to around zero by 2028.

37 AMECO database, the 2025 autumn forecast of the European Commission.

Box 6: The speed of GDP growth in countries with a similar income level to Estonia at purchasing power parity

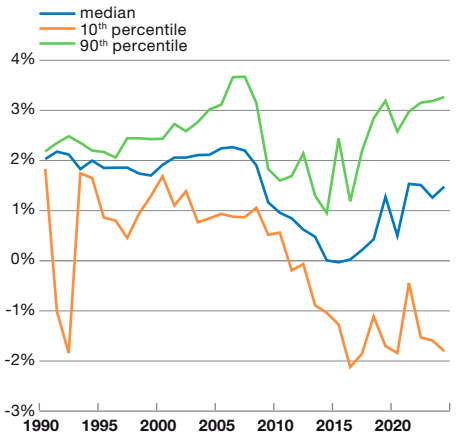
Growth in the Estonian economy has slowed over time. It is often said that the low hanging fruit have already been harvested and that the more complex an economy is, the harder it becomes for it to grow fast. A couple of decades ago it was possible to increase productivity by learning from the experiences of wealthier countries, but by now there are a lot fewer countries that can serve as an example.

This can be expressed numerically. One way of doing so is to analyse how fast GDP has grown in countries that have a similar income level to Estonia. This can be done with data from the IMF on the average economic growth over a decade in different countries starting from the 1980s. Estonia can be compared with countries where GDP per capita at purchasing power parity at the start of the period was no more than 15% larger or smaller than that in Estonia in 2024. The figure for 1990 for example can be found by choosing those countries within all countries where GDP per capita adjusted for the price level was similar in 1980 to the GDP per capita in Estonia in 2024. The data point is found by calculating the average economic growth for those countries between 1980 and 1990.

Figure B6.1 illustrates that the countries that had a similar income level to that of Estonia last year saw average growth in GDP per capita over the decade up to the global financial crisis of 2008 of around 2% a year. Economic growth in these countries over the past decade has been around 1.5% a year.

It also emerges that the differences in rates of growth between the countries with faster and

Figure B6.1. Average GDP growth in countries with a similar income level to that in Estonia in 2024



Sources: IMF, Eesti Pank

slower economic growth have been wider in the past decade than they were in earlier decades. GDP per capita in the countries with faster growth and a similar income level to Estonia has grown by around 3% a year, while in some other countries it has actually declined.

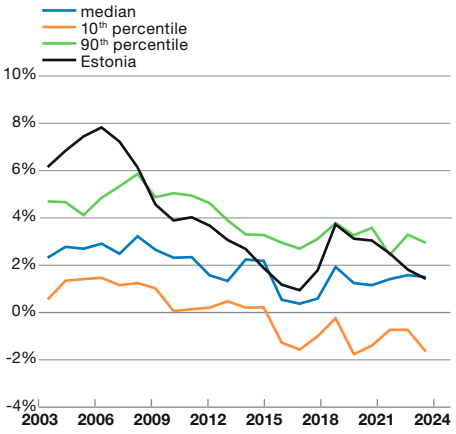
Estonia can also be compared in a similar way with countries where the income level at the start of the decade in question was similar to the level in Estonia at the same time, meaning it was no more than 15% larger or smaller. To obtain the figure for 2024, a sample of countries was constructed whose GDP per capita in 2014 was similar to that of Estonia in 2014, and the average economic growth over the period from 2014 to 2024 was then calculated as described above.

Figure B6.2 illustrates that growth in GDP in those countries was a little faster before the global financial crisis, which may be expected if the potential for growth diminishes in countries where the standard of living is rising. It is also apparent that GDP per capita in Estonia has generally grown faster than the average figure for countries that started with a similar income level to Estonia. GDP per capita in Estonia has however grown at around same rate over the past decade as in the median country that had a similar income level a decade ago to that in Estonia.

The average GDP growth per capita over the past decade in countries similar to Estonia can also be shown as a histogram (see Figure B6.3). This shows that the most common rate of growth in such countries over the past decade was in the range of 1.5%-2%, although some countries managed to exceed that rate. Countries that had a similar income level to Estonia but where economic growth was faster were Malta and Cyprus, where yearly GDP growth in that period averaged around 4%.

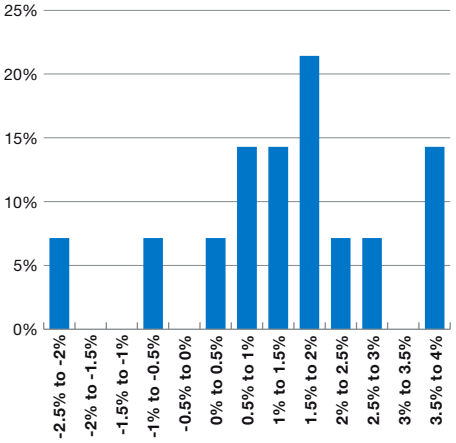
Overall countries that have a similar income level to Estonia have seen slightly slower growth in GDP per capita over the past decade than the rate experienced earlier in Estonia. Growth in the Estonian economy in the coming years should still exceed the long-term average rate, as the output gap is negative and the economy can still grow a little faster because of its cyclical position. It is probable in the long term though that growth will be slower, as it has been in other countries.

Figure B6.2. Average GDP growth in countries with a similar income level to that in Estonia



Sources: IMF, Eesti Pank

Figure B6.3. Distribution of GDP growth in countries with a similar income level to that in Estonia



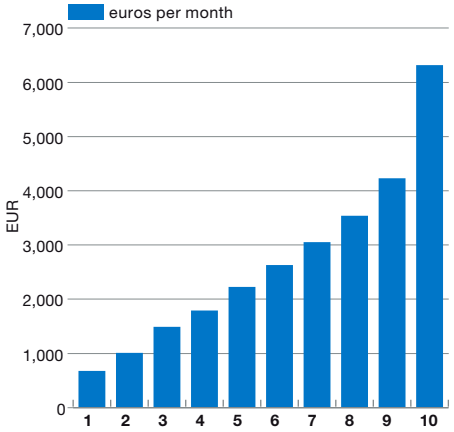
Sources: IMF, Eesti Pank

Box 7. How the changes to the income tax system in 2026 will affect the consumption and saving of households

There will be a single threshold of tax-free income[38] from 2026 that will not depend on the level of income. The change to the law that raises the tax-free threshold to 700 euros a month will hand households an estimated additional 700 million euros. The biggest individual financial gain will be 154 euros a month for those earning 2100 euros a month or more in income. This box considers how the additional income will be distributed between various income groups, and how much of the gain households will use for consumption depending on their propensity to consume.

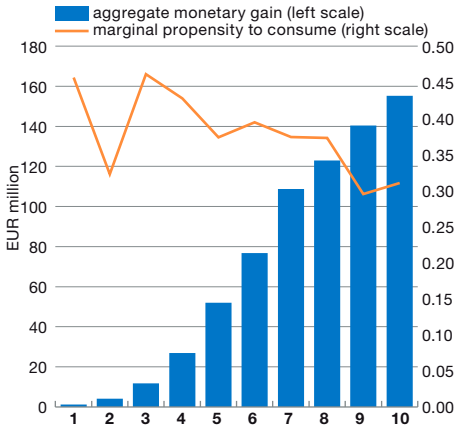
The financial gain from the change to the income tax system and how it is distributed between families differs when viewed from the individual income distribution. Figure B7.1 shows the incomes of households by decile, though the make-up of the households in each decile is very different and this will partly dictate the amount of additional income that households receive from the tax changes. The average gain in the 10th or highest decile for income will be around 210 euros for example because there are a lot of households in that decile with multiple income earners and so the total additional income gained by the whole household is larger than the individual maximum of 154 euros. The average for the decile is brought down though by single-member households who cannot gain more than 154 euros, and also by those households where a high-income earner lives together with other household members with a small income or none at all.

Figure B7.1. Mean household income by deciles in 2024



Sources: Euromod, Eesti Pank

Figure B7.2. Gain from the change in the income tax system and the marginal propensity to consume by income decile



Sources: Euromod, Eesti Pank

To estimate how much one or another income group gains on average and in total from the tax changes, and how much the additional income for the whole household sector is, the Euromod online tool has been used. Euromod starts from the income statistics from the last full year, which is 2024 here. The expected increase in income by 2026 is used to estimate the additional income of the whole household sector. The increase in total income and its distribution across the different income deciles have been estimated from the distribution of household income in 2024 (see Figure B7.2).

The household finance and consumption survey[39] can be used to draw conclusions about the marginal propensity to consume within different income deciles, as people are asked about how

38 The income tax-free threshold will be set at 8400 euros a year or 700 euros a month from 2026.

39 Household Finance and Consumption Survey, HFCS 2021. One question asked respondents how much of an unexpected income equivalent to one month of pay they would spend during the year on goods and services.

they would use a one-off additional windfall income. The propensity to consume varies across income deciles, as people with the smallest incomes have an average marginal propensity to consume extraordinary income of around 0.46, while in groups with higher incomes this falls to 0.3 (see Figure B7 2).

All the income deciles gain from the change to income tax, but it is estimated that 80% of the additional income will go to the upper 50%, who spend a smaller proportion of their income on consumption than people on lower incomes do. This means the distribution of the additional money across income groups is uneven, and so is the expected consumption of it.

If households were to follow the marginal propensity to consume of their income group, as shown in Figure B7.2, around a third of the additional income would be consumed, and the rest would go into savings. The average marginal propensity to consume unexpected income across all income deciles was 0.38 in the survey.

These marginal propensities to consume are however found from a question about windfall income, while the reorganisation of the tax system will produce additional income that is permanent in nature. People generally spend more of an increase in income that is permanent in nature. The literature has found that the marginal propensity to consume permanent income is around 0.8[40], which is about double the estimate found from the question in the survey.

There are several factors that could affect the propensity to consume even further.

Not only the nature of the rise in income as permanent or temporary needs to be considered, but also the actual amount of the increase. The additional amount given to households[41] by the change to the income tax system will be less than 100 euros a month on average, and a little over 200 euros per household at most. This amount is very different to the payouts from the second pension pillar for example, when an extraordinary windfall worth several months of income can be received in one go, and it is estimated that around half of the first large payout on average is spent within the year. The literature on the subject has also noted that smaller amounts of additional income are generally spent to a larger extent than very large windfalls. The extra amount given each month by the change to the tax system will average around 3% of the income of the household, and it will probably be consumed more than would a one-off large income flow worth several months of salary.

The marginal propensity to consume is also affected by the liquidity limits of the household, as tighter limits increase the probability that a large part of the additional income will be consumed. Around a third of households in Estonia live hand to mouth, which means that they spend the whole of their income each month and do not build up any savings[42]. Households living hand to mouth are not necessarily only to be found in the lowest deciles of the income distribution, and there is very probably a group that will spend all of their additional income.

The reaction of consumers to changes in income is generally smooth, and so their immediate reaction to an increase in income is quite restrained. Households try to maintain their habitual relationship between income and savings, and this then shifts after some time when income

40 Papers on the subject include: Carroll (NBER): *Precautionary Saving and the Marginal Propensity to Consume out of Permanent Income,* http://www.nber.org/papers/w8233. The marginal propensity to consume after a permanent shock to income was between 0.75 and 0.92.
Agarwal and Quian: *Consumption and Debt Response to Unanticipated Income Shocks: Evidence from a Natural Experiment in Singapore (2014).* The marginal propensity to consume was 0.8 10 months after the financial stimulus https://www.aeaweb.org/articles?id=10.1257/aer.104.12.4205.
Paulo Lins: *Consumption's Response to Permanent Income 2025,* https://pauloclins.com/files/permanent_income.pdf.

41 The consumption elasticity to an increase in income was 0.9 for younger households and 0.6 for older ones.

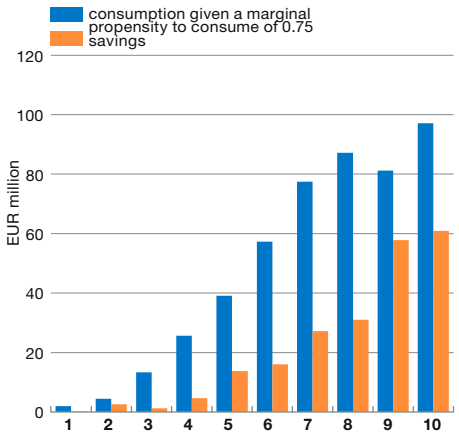
42 Jaanika Meriküll, Tairi Rõõm: *The Estonian Household Finance and Consumption Survey 2017* (2019). https://haldus.eestipank.ee/sites/default/files/publication/en/occasionalpapers/2019/ep_op_01_2019_taiendatud_4.pdf.

rises. The increase in income will consequently encourage some increase in saving, at least at first.

Taking all of this together suggests that the marginal propensity to consume the additional income will on average be less in the first year than the literature indicates at around 75%. This also accounts for the time needed for the adjustment as the propensity to consume rises gradually to its expected level, and the distribution of the additional income across income groups.

Given the different marginal propensities to consume of the income deciles, around 485 million euros of the additional income would in this case go to consumption, and 215 million euros would be saved across the year (see Figure B7.3).

Figure B7.3. Consumption of the additional income from the income tax change in 2026 by income decile



Sources: Euromod, Eesti Pank

The impact of the income tax change will be that consumption increases next year by around two percentage points more than it would have otherwise. The uneven distribution of the additional income across income deciles and the modest additional spending in the first quarters of the year mean though that some of the money will go into savings and so the household saving rate will be around 0.6 percentage point higher in 2026 as a result of the income tax reform.

PRICES

Inflation will continue to fall. It will mainly be domestic factors that cause demand-side price pressures, particularly the large budget deficit, while import prices will restrain inflation. Domestic price pressures will be offset by faster growth in the economy and increased productivity.

Government tax policy will affect the level of inflation in the years ahead. The rise in VAT will continue to be reflected in the price statistics in the first half of 2026 while alcohol and tobacco excise will rise by 10% in January 2026. At the same time the impact of the registration fee for cars, which added around 1.2 percentage points to inflation this year, will pass out in the new year. Although the impact of tax rises on prices will decrease, the large budget deficit and the injection of additional money from it into the economy will pose the risk of inflation being higher than expected. Equally the introduction of the tax-free income threshold and the consequent growth in domestic demand will push inflation up by an estimated 0.3 percentage point.

Patterns of price changes for different groups of goods and services will be quite varied. Inflation for food and services will come down in the first half of 2026, at the same time that inflation for manufactured goods will gradually pick up from its earlier low level. Food price inflation falling should be supported by prices for commodities being lower, which should then pass through into the local retail market. Inflation for services being lower will mean that wage costs rise more moderately. Inflation for non-energy industrial goods will start to accelerate, but will remain modest because import prices will rise slowly.

Energy prices are only moving towards their long-term level. The price of gas has fallen back to the low level it was at before the energy crisis. The price level of electricity may fall, but the increase in the share of renewable energy means prices will start to follow a much stronger seasonal pattern. A rise in network fees for electricity is a risk factor, though the oil price is expected to remain relatively low. The introduction of ETS2 has been postponed until 2028, and that will add an estimated 0.5 percentage point to inflation.

THE GENERAL GOVERNMENT FISCAL POSITION

The budget deficit will be smaller this year than it was last year at 1.3% of GDP. There are various reasons why the deficit will be smaller than in earlier years and notably smaller than was planned in the budget for 2025. The most important include the large one-off inflow of corporate income tax at the start of the year, the labour market performing better than expected meaning receipts of labour taxes exceeded expectations, and the state spending less on investment than was earlier planned.

The budget deficit will increase to 4.5% of GDP in 2026. There are two main factors driving the deficit. The first is that the change to the income tax system will start to apply and will eliminate the progressive tax-free income principle and apply a single rate for it. The direct impact will be that this worsens the budget balance by around 1.5% of GDP, and without this change the deficit would have been around 3% of GDP next year. The second factor is that the plans accounted for in the forecast will raise spending on national defence above 5% of GDP, increasing it by 1.3 percentage points from 2025. Some of the increase in the deficit will go into a fiscal stimulus to the economy, but it will make the budget less sustainable at the same time, accelerate the growth in the debt level and interest costs, and leave unclear when and how the deficit will start to be closed.

The forecast assumes that the budget deficit will remain large in the coming years. The change to the income tax system and the increase in spending on defence are of permanent nature, though there is not permanent cover for them, and so the budget will remain in deep deficit in the coming years if there is no change in policy. The deficit will narrow a little in 2028 as the economy grows and cost pressures weaken a little.