# The Estonian Economy and Monetary Policy

Eesti Pank
EUROSÜSTEEM

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**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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# CONTENTS


INTRODUCTION ..... 4

THE EXTERNAL ENVIRONMENT ..... 5

- The global economy ..... 5
- The euro area ..... 8
- Box 1: Monetary policy in the euro area ..... 10
- Estonia's main trading partners ..... 11

THE ESTONIAN ECONOMY ..... 14

- Economic activity ..... 14
- Box 2: How productivity in Estonia compares with that in other Baltic and Nordic countries ..... 16
- Domestic demand ..... 18
- External balance and competitiveness ..... 19
- The labour market ..... 21
- Prices ..... 24
- General government financing ..... 25

THE EESTI PANK ECONOMIC FORECAST FOR 2026-2028 ..... 26

- The international economic environment ..... 26
- Technical assumptions used in the forecast ..... 27
- Economic growth ..... 28
- Prices ..... 31
- General government financing ..... 31
- Box 3: Alternative scenarios for the economic impact of the conflict in the Middle East ..... 32
- Box 4: The budget deficit that stops the debt ratio growing ..... 34

# INTRODUCTION

**The geopolitical tensions that are overshadowing the global economy have also reached Estonia,** though their impact on the economy has not particularly been felt yet. War in the Middle East, trade restrictions and general uncertainty have chilled the external environment and increased risks, but the Estonian economy still continued to recover in the first half of the year. It was supported in this above all by strong domestic demand, which was boosted by an expansive fiscal policy. Geopolitical problems lasting for longer and becoming more intensive could however arrest the recovery in the economy through deeper supply problems, elevated energy prices, or higher interest rates.

**The updated economic forecast in this review finds that increased spending by the state this year will give strong impetus to growth in the Estonian economy.** Domestic demand has been increased notably by the larger budget deficit and the loans taken by the state to finance it. This compensates to some extent for the weak growth in purchasing power in foreign markets and the consequent limits on options for exports. The economy will grow by 2.4% this year, largely through increased spending by private individuals and the general government, which is an evident improvement on recent years. If the situation in the Middle East is alleviated soon, growth will remain around 2.5% in the next two years as well.

**The reaction of the labour market to the recovery in the economy is proving mild.** Some production equipment at companies is standing idle and employees were maintained in post while the economy was experiencing difficulties by reducing the actual number of hours worked, and so an increase in economic activity in the coming years will probably not prompt an increase in employment, but rather in hours worked and in output per person employed. This means that increased demand will improve productivity in the short term. Achieving long-term and sustainable growth in the economy however needs companies to move towards creating products and services that have greater value added. Although interest rates have risen to some extent, the financing conditions for investments remain favourable.

**Inflation is falling.** Inflation was pushed up in recent months mainly by prices for motor fuels rising, but it still remains moderate. The price of the consumer basket has risen by around 2% in recent months if the impact of tax changes is left aside, and this is close to the monetary policy target of the euro area. The current situation affects a smaller range of fuels than the energy crisis of 2022 did, and so the impact on the total cost of the consumer basket is smaller. There remains however a lot of uncertainty about where inflation may go next, as it depends on the resolution of the crisis in the Middle East and on the geopolitical situation more broadly. The baseline scenario of the Eesti Pank forecast expects the cost of living to rise by as much as 3.4% this year, with inflation remaining around 2.5% in the next two years.

**This quarterly review contains one box that describes the monetary policy decisions of the euro area as usual.** Another analyses productivity in manufacturing and in the economy on average in comparison to neighbouring countries in order to identify possible pinch points. As there is so much uncertainty around the outlook for the economy, this review also offers alternative forecast scenarios that describe possible deviations from the baseline scenario if the situation in the Middle East is not resolved as expected. There is also a short analysis of the fiscal position that would stop the Estonian state debt from growing.

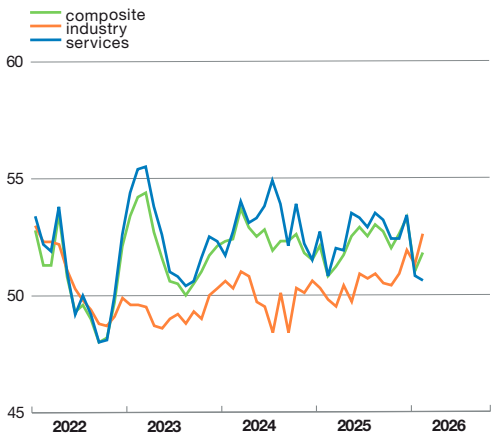
# THE EXTERNAL ENVIRONMENT

## THE GLOBAL ECONOMY

**The global economy continued to grow even as geopolitical uncertainty increased sharply.** The International Monetary Fund (IMF) estimates that strong private consumption and favourable financing conditions were the main pillars supporting economic activity. Growth was largely driven by technology investments in the USA and Asia, as companies increased their spending on artificial intelligence, data processing, and developing production capacity for semiconductors. Geopolitical uncertainty weighed increasingly heavily on the global economy though, and was elevated further by the war in the Middle East. That conflict caused widespread disruptions in energy markets and caused the prices of oil, gas and several other commodities to rise. It also pushed inflation upwards, which was particularly apparent in Asia, especially Korea, Singapore and India. The global economy also showed some signs of moderate revival in April as the purchasing managers index (PMI) climbed to 51.8 points (see Figure 1)[1]. The rise was supported primarily by an increase in activity in manufacturing, where the PMI rose to 52.6 points in April. The growth in manufacturing came partly from temporary stocking up of inventories as companies feared supply difficulties and rising prices. Growth has remained relatively strong in international trade, with particular support from demand for technology-related goods (see Figure 2). This demand has received notable support from exports of semiconductors and electronics from Asia.

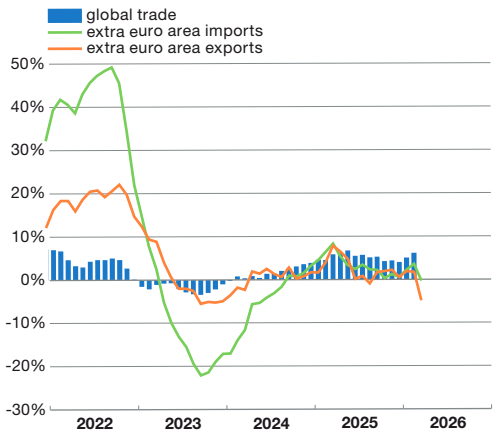
**The conflict in the Middle East has so far had a limited impact on economic activity across countries, and there are several reasons for this.** The first is that advanced economies have become less dependent on energy supplies from the Middle East, as several of them have in recent years diversified their energy sources by increasing the share of renewable energy and investing in liquefied natural gas (LNG) infrastructure and domestic energy production. A second is that the earlier crises in the global economy have made it more resilient. Businesses have adapted their supply chains, increased their inventories and made their production less energy intensive.

Figure 1. Purchasing Managers Indexes




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

Figure 2. Yearly growth in global and euro area trade, three-month moving average




Sources: CPB, Eurostat

The use of strategic energy stocks and the weakness of demand have also helped avoid the oil price spiking more sharply.

**Growth in the largest advanced economies remained moderate in the first quarter.** The US economy grew by 0.4% over the quarter, which was slower than the 0.6% growth in the fourth quarter of last year (see Table 1). Slower growth in private consumption was the main factor applying the brakes to economic activity, while capital investment in the technology sector and the infrastructure needed for artificial intelligence continued to drive corporate investment. Increased general government spending also contributed

1 J.P.Morgan Global Composite PMI.

Table 1. GDP growth in different regions in 2020-2026 (change, %)*

| | 2021 | 2022 | 2023 | 2024 | 2025 | Q4 2025 | Q1 2026 | 2026 |
|---|---|---|---|---|---|---|---|---|
| World | 6.0 | 3.4 | 3.5 | 3.3 | 3.4 | | | 3.1 |
| Advanced economies | 5.2 | 2.7 | 1.8 | 1.8 | 1.9 | | | 1.8 |
| Emerging markets and developing economies | 6.6 | 4.0 | 4.7 | 4.3 | 4.4 | | | 3.9 |
| Euro area | 6.4 | 3.6 | 0.4 | 0.9 | 1.4 | 1.2 (0.2) | 0.3 (-0.2) | 1.1 |
| United States | 6.1 | 2.5 | 2.9 | 2.8 | 2.1 | 2.0 (0.1) | 2.7 (0.4) | 2.3 |
| China | 8.6 | 3.1 | 5.4 | 5.0 | 5.0 | 4.5 (1.2) | 5.0 (1.3) | 4.4 |
| Japan | 3.6 | 1.3 | 0.7 | -0.2 | 1.1 | 0.2 (0.2) | 0.6 (0.5) | 0.7 |
| United Kingdom | 8.5 | 5.1 | 0.3 | 1.0 | 1.4 | 1.0 (0.2) | 1.1 (0.6) | 0.8 |

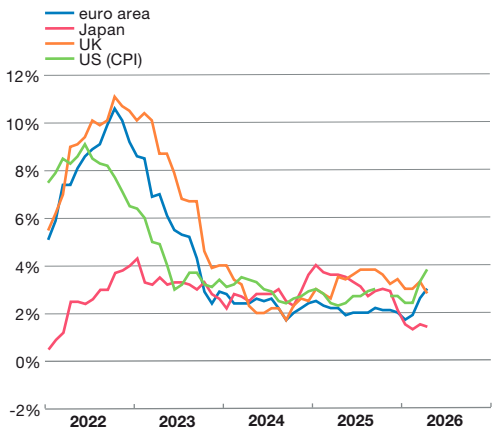
* GDP at constant prices, quarterly growth over the previous quarter is in brackets
Sources: IMF World Economic Outlook (April 2026), OECD, Eurostat, National Statistics; 2026 is IMF estimate

after the shutdown of the federal government ended. The economy in the United Kingdom grew by 0.1% in the first quarter, as weakness in services and construction restrained growth. The Japanese economy grew by around 0.5% over the quarter in the first quarter, with the main support coming from private consumption and public sector investment, which started to grow again after three quarters of not doing so.

**The Federal Reserve remained cautious in the face of increased inflation pressures.** Consumer price inflation over the year in the USA increased from 3.3% in March to 3.8% in April as higher fuel prices pushed it to its highest level for three years. The Federal Reserve held its base interest rate unchanged in April at 3.50–3.75% after a majority vote of eight to four. This was the first time since 1992 that four members of the Federal Open Market Committee (FOMC) voted against the decision. Financial markets were still assuming at the end of 2025 that the Federal Reserve would start to cut interest rates in 2026. The rises in inflation figures and energy prices in recent months mean however that the next step for the Federal Reserve will be to raise base interest rates, probably in the autumn.

**The United Kingdom and Japan held their interest rates where they were, while Australia raised its base rate.** Consumer price inflation in the United Kingdom slowed from 3.3% in March to 2.8% in April. A cap on energy prices that started to apply from 1 April helped slow inflation and the Bank of England held its base interest rate unchanged in April at 3.75%. The yearly growth in consumer prices in Japan was 1.4% in April. The Japanese central bank maintained its short-term base interest rate at 0.75% at the end of April,

Figure 3. Inflation




Sources: Eurostat, Bloomberg

which is its highest level since the mid-1990s. The only central bank in a large advanced economy that has raised its base rate in recent times has been the Reserve Bank of Australia, which raised its base rate by 25 basis points in May to 4.35% as the risk had increased of price pressures spreading more broadly across the whole economy.

**Economic growth in emerging regions in Asia remains relatively strong.** Economies in India, Vietnam and several Southeast Asian nations grew particularly strongly, as production of semiconductors, electronics and electric vehicles increased. Exports from Vietnam were up 19.1% over the year in the first quarter and exports of semiconductors and electronic components reached record levels. Official data showed that the Chinese economy grew by 5% over the year in the first quarter, but alternative estimates indicate that growth was closer to 4-4.5%[2]. The main drivers of industry and exports were electric

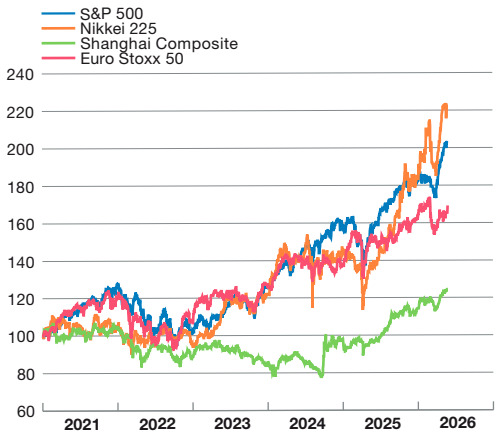
2 BOFIT (2026). BOFIT Forecast for China 2026–2028. Bank of Finland Institute for Emerging Economies.

vehicles, batteries and solar panels, but domestic demand was weak at the same time because of a decline in the real estate sector, uncertainty in the labour market, and slow growth in wages. Producer prices started to grow again in spring after falling for a long time and they were 2.8% higher over the year in April, which was the largest increase since July 2022. Prices rose mainly because supply difficulties resulting from the war in Iran made energy and commodities more expensive. Preliminary data indicate that the Indian economy grew by around 7.5% over the year in the first quarter. Growth in the Indian economy, unlike that in China, is built mainly on domestic demand, digital services and public sector investment, and less on a trade surplus.

**Global stock markets started to rise again.** The S&P 500 index in the USA fell sharply in March but rose by around 10.5% over the month in April, which was the largest monthly rise since November 2020. It then climbed to a new record level in May. Strong corporate financial results in the first quarter and the outlook for profits remaining favourable helped stock markets recover. Share prices rose most for large companies working with artificial intelligence, but the overall rise in prices was quite broadly based. Both the S&P 400 index for medium-sized companies in the USA and the S&P 600 for small companies reached new record levels. Stock markets in Europe also rebounded, though they rose by less than US markets. The Euro Stoxx 50 index was also boosted mainly by technology shares and the hope that tensions in the Middle East were starting to ease. The increase was however restrained by higher energy prices and uncertainty about the future path of interest rates, and so the index remained below the peak it had reached in February. The Japanese stock market recovered from its sharp drop in March and the Nikkei 225 index reached a new record level at the end of May.

**Bond yields rose in April to new peaks in several places around the world.** This is because the expectations of investors for monetary policy had changed, as the sharp rise in energy prices had reduced expectations of further cuts in interest rates and increased the conviction that rates would remain higher for longer than was previously thought. The consequence was that the yield on the US 10-year Treasury approached 4.6% by the end of May, which is its highest level of the past year and a half. Yields on the 10-year

Figure 4. World stock indexes (01.01.2021 = 100)




Last observation 25.05.2026
Source: Bloomberg

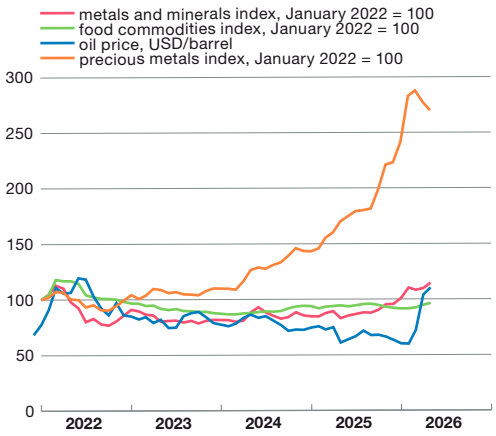
bonds of the United Kingdom rose as high as 5.2%, which is a level not seen since the global financial crisis. Political uncertainty pushed yields higher as investors became more concerned about the outlook for fiscal policy. The yield on the German 10-year bond rose at the same time to around 3.2%, which is its highest level of the past 15 years.

**Selling pressure in bond markets eased in May though, especially in Europe.** This was helped by energy prices coming down from their peaks of March, and investors expecting that inflation pressures would be reduced if geopolitical tensions eased. The yield on the German 10-year bond had come down to 3.0% by the end of May, while that on the French 10-year bond was around 3.6%. The yield on bonds in Japan meanwhile rose to its highest level of the past 30 years at close to 2.8%, as higher core inflation and the supplementary budget planned by the government increased expectations that interest rates would rise. It was also notable that for the first time since the early 2000s the yield on the Japanese 10-year bond was higher than that on the equivalent Chinese bond, which was 1.75% as China struggled with deflation.

**Commodity prices rose sharply in March, but then came down a little.** The war in the Middle East and the closure of the Strait of Hormuz made the price of Brent crude volatile, and it mainly swung between 100 and 110 dollars a barrel in April and May. The price of natural gas in Europe fell from the peak of 60 euros per megawatt-hour that it hit in March to around 45 euros. Volatility in

energy prices affected other commodities markets as well. The price of fertiliser was particularly clearly affected, as the Middle East is one of the main exporters of ammonia and other inputs used in agriculture. The price of urea, which is a widely used nitrogen-based fertiliser, jumped by around 50% at the start of the conflict to 700 dollars a tonne, but it then fell in subsequent months by about a third to around 500 dollars a tonne. Prices for industrial metals in contrast continued to rise. Prices for copper, aluminium and lithium were affected by geopolitical tensions, and at the same time by strong demand that is driven by large investments in data centres, electric vehicles and renewable energy. Prices for precious metals meanwhile mainly moved downwards. Gold, which had peaked at over 5200 dollars an ounce at the end of February, was trading about 15% below that at the end of May at around 4500 dollars an ounce. Prices for food commodities mostly rose in March and April, mainly because vegetable oils, meat and grain became more expensive.

Figure 5. Commodity price indexes




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

## THE EURO AREA

**The state of the euro area economy has weakened as the year has progressed.** It was still in a relatively good position at the start of the first quarter, as the uncertainty and the problems in global trade caused by war in the Middle East had not yet had a major impact on the economy, but that impact then started to be felt more and more. There was a substantial drop in May in the estimate of economic activity in the euro area. The aggregate PMI index[3] fell in April from 48.8 points to 48.5 points, which is the largest fall in a year and a half. Production volumes and numbers of new orders fell faster than before, and business sentiment remained weak. This all led companies in the euro area to start to reduce their labour force. In total these indicators suggest that growth in the euro area economy will slow further in the second quarter.

**GDP in the euro area fell in the first quarter.** It was down by 0.2% in the first quarter having grown by 0.2% in the previous quarter, while the growth over the year was 0.3%. Growth was held back by rises in energy prices, shortages of raw materials and higher transport costs that all resulted from the war in the Middle East. The impact of the conflict only started to be felt at the end of the quarter, and so the main negative factor impacting the aggregate GDP figures for the euro area was the large fall in GDP in Ireland[4]. Among the larger countries in the euro area, France saw GDP decline by 0.1% in the first quarter, while the Italian economy grew by 0.3% and growth in Germany was lifted by exports and increased public sector spending to 0.3%. The fastest growth in the euro area was again in Spain, where it was 0.6%. In the near future the war in the Middle East will weaken the outlook for growth in the euro area substantially.

**One of the main reasons that economic activity was weaker was that cost pressures were greater.** The survey data for the PMI show that input prices rose in May at the fastest rate since 2022 and that selling prices also rose increasingly quickly. The economic sector where weaker activity most affected the fall in the aggregate PMI in May was services, as demand for services declined. Activity in industry weakened less meanwhile, as companies increased their inventories and so gave support to production and sales in manufacturing in particular. Increasing disruptions to supply chains and delays in supplies will cause a sharp contraction in inventories however. Export orders fell again, indicating that foreign demand for output from the euro area has not improved. National PMI data indicate that the drop in activity in May was particularly evident in France.

3 S&P Global Eurozone Composite PMI®.

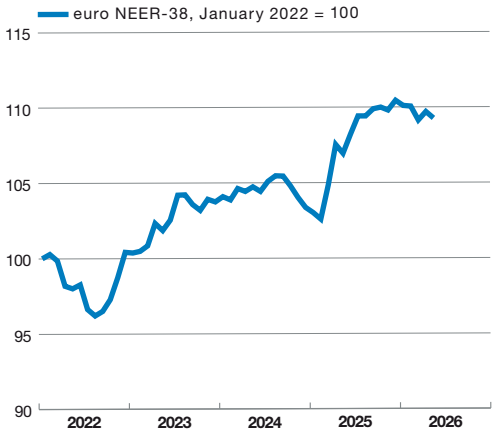
4 Irish GDP dropped by 12.1% over the quarter, mainly because of the high reference base from last year. A large number of international technology and medical firms operate in Ireland, and their activities have a substantial impact on the national statistics.

**Industrial output declined, but retail sales volumes continued to grow.** Industrial output in the euro area in March was 2.1% below where it was a year earlier, though it grew a little over the month, as production of capital goods and intermediate goods increased. Yearly growth in retail sales remained quite good in the euro area in March at 1.2%. Retail sales were down over the month though, mainly because sales of fuel fell. The uncertainty continues to prompt a lot of people to save and consumer confidence remains below its long-term average level, but private consumption continues to support the economy in the euro area.

**The trade surplus of the euro area narrowed.** The trade surplus in March was 7.8 billion euros smaller than a year earlier, as exports were 5.5% lower in March than a year previously while imports were up by 4.4%. The biggest decline in exports was in chemical products and machinery and equipment, and the destinations for exports that saw the largest declines in them were the USA and Turkey. Imports grew most at the same time from China and the USA. The nominal effective exchange rate of the euro (NEER) has again started to depreciate since the end of April against the currencies of the euro area's main trading partners, including the US dollar (see Figure 6). A weaker euro should make companies in the euro area a little more competitive in foreign markets. The looser monetary policy in the euro area has also helped keep financing conditions favourable so far, aiding companies in the euro area in coping better during the uncertain times (see Box 1).

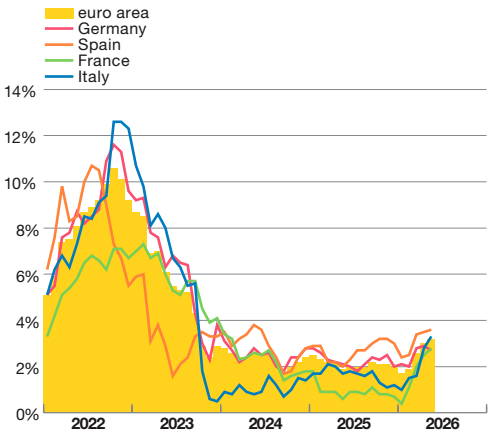
**Yearly inflation in the euro area picked up from 3.0% in April to 3.2% in May** (see Figure 7). This was the highest rate of inflation since September 2023. Energy prices rose by 10.9%, which was the fastest rate since February 2023 and was mainly a consequence of the supply chain difficulties caused by the war in the Middle East. Inflation for services and manufactured goods was also higher than in April, while that for food, alcohol and tobacco was down. Core inflation without energy and food rose from 2.2% to 2.5%, indicating that price pressures have spread more widely beyond just the energy sector (see Figure 8). Inflation in the largest countries of the euro area rose most in Spain, where it reached 3.6%, and Italy, where it was 3.3%, but it also rose in France to 2.8% while it fell in Germany from 2.9% in April

Figure 6. Trade-weighted euro exchange rate



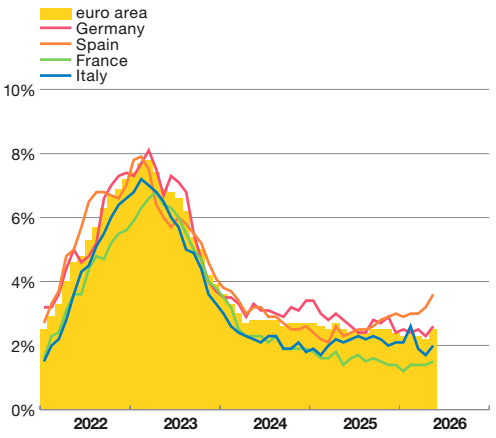

Source: European Central Bank

Figure 7. HICP inflation




Source: Eurostat

Figure 8. Core inflation

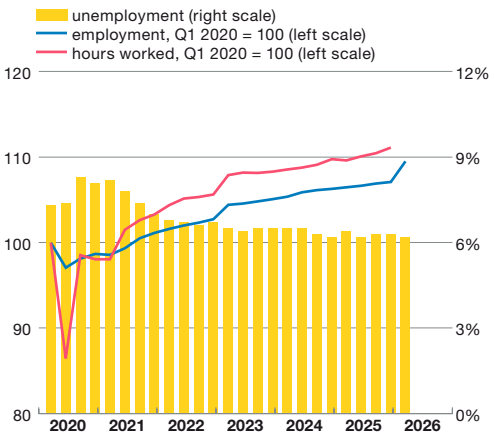



Source: Eurostat

to 2.7%. Higher prices for inputs have caused producer prices in the euro area to rise faster as well. The largest rise in producer prices happened in March though, and they are now climbing a little more slowly.

**The labour market in the euro area remains good for employees.** The latest survey data indicate some fall in jobs and weaker expectations for employment among businesses[5]. Unemployment remained low at 6.3% in April, while the employment rate stayed at around its historical peak (see Figure 9). The number of people in employment was 0.5% higher in the first quarter than a year earlier. Wage growth in the euro area remains a little over 3% but is gradually coming down, and growth in negotiated wages came down to 2.5% in the first quarter.

Figure 9. Employment and unemployment in the euro area



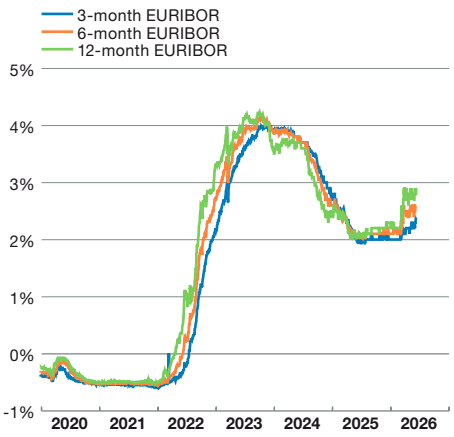

Source: Eurostat

5 The Employment Expectations Indicator, The Commission's harmonised Business and Consumer Survey.

## *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 has picked up in the euro area in recent months, mainly because the war in the Middle East has pushed energy prices higher. The baseline scenario in the June forecast by the Eurosystem projects that inflation will average 3.0% this year, after which it will fall to 2.3% in 2027 and 2.0% in 2028. This means that inflation is expected to remain above its target of 2% for some time yet. To help bring inflation in the euro area down towards its target, the Governing Council of the European Central Bank decided at its meeting in June to tighten monetary policy.

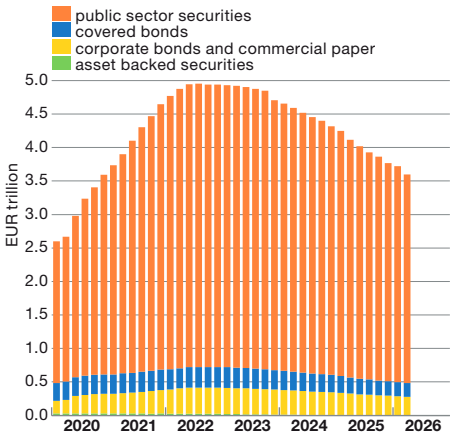
Figure B1.3. Euro area money market interest rates




Last observation 09.06.2026
Source: Bloomberg

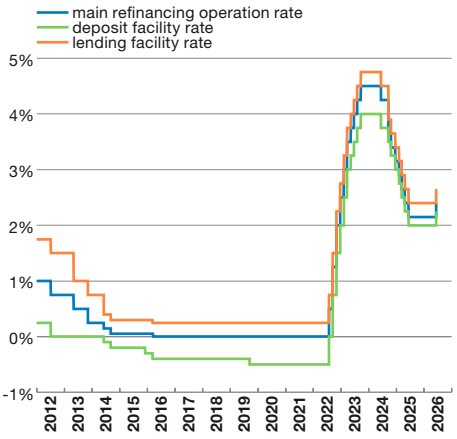
The Governing Council raised its three key interest rates by 0.25 percentage point in June (see Figure B1.1). The interest rate on main refinancing operations is now 2.40%, the marginal lending rate is 2.65%, and the deposit facility rate is 2.25%. The Governing Council emphasised that it is not pre-committing to a particular rate path moving forwards. The Governing Council's 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.

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




Last observation 31.03.2026
Source: European Central Bank

Figure B1.1. Eurosystem key interest rates




Last observation 11.06.2026
Source: European Central Bank

The balance sheet of the Eurosystem is shrinking because the bonds purchased under the various asset purchase programmes are gradually reaching maturity[6]. 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 March was 3.6 trillion euros (see Figure B1.2).

Interest rates have risen recently in the interbank money market, partly reflecting the expectation of market participants that monetary policy interest rates will be tightened (see Figure B1.3). As at 9 June the 3-month Euribor was at 2.37%, the 6-month Euribor was at 2.61%, and the 12-month Euribor was at 2.87%. The growth in the money supply in the euro area has slowed a little and the yearly growth in the broader M3 indicator was 2.7% in April. Yearly growth in corporate borrowing has picked up in recent months, and was 3.4% in April. The yearly growth in lending volumes to households remained at 3%. The Governing Council considers that the capital and liquidity positions of the banks in the euro area remain strong.

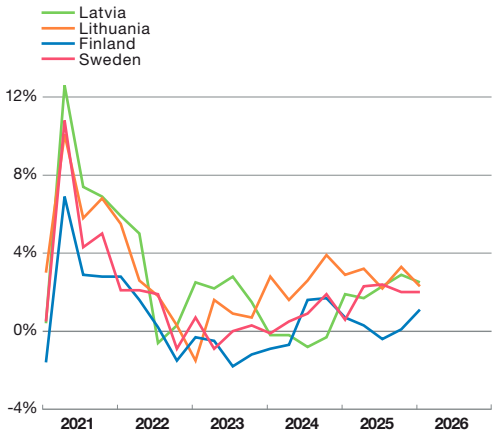
6 The Eurosystem is no longer reinvesting the principal repayments received from maturing securities. Reinvestment of bonds purchased under the asset purchase programme (APP) was discontinued in July 2023 and reinvestments under the pandemic emergency purchase programme (PEPP) were discontinued at the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

## ESTONIA'S MAIN TRADING PARTNERS

**Rates of growth were quite different in the economies of Estonia's main trading partners in the first quarter.** Particularly noticeable was that the Finnish and Latvian economies continued to grow, while the Swedish and Lithuanian economies unexpectedly contracted. GDP in Finland was 0.9% larger in the first quarter than in the fourth quarter of last year. The growth on the demand side came from private consumption, exports and investment, including increased investment in defence. GDP in Sweden though was down by 0.2% over the quarter as activity in manufacturing was weaker, retail sales were down, and goods exports declined. The Lithuanian economy, which had previously stood out for having the fastest growth in the region, also saw GDP shrink by 0.3% over the first quarter. This was the first quarter of decline in Lithuania since 2023 and was mainly the result of weaker results in construction, wholesale and retail, and transport. Growth over the year was still good in the Swedish and Lithuanian economies though, at 2% in Sweden and 2.3% in Lithuania (see Figure 10).

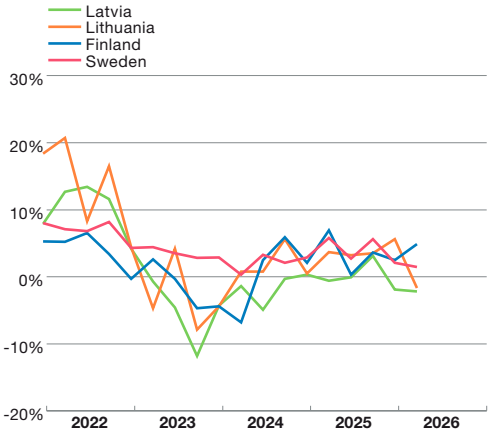
**Manufacturing has continued to perform relatively well in Estonia's main trading partners despite the difficulties in the external environment.** Industrial output was down over the quarter in Sweden in March after strong results in the first months of the year, but the Swedish industrial sector overall continues

Figure 10. Yearly growth rates of GDP of trading partners




Source: Eurostat

Figure 11. Yearly export growth of trading partners



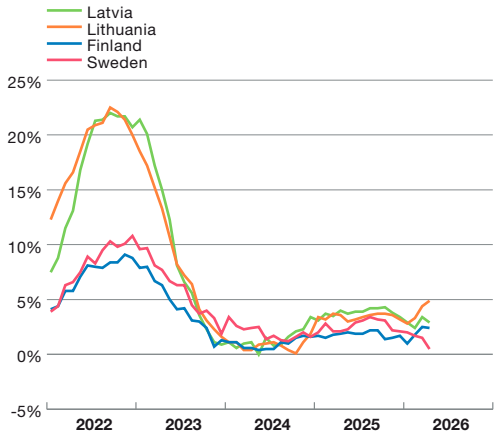

Source: Eurostat

to be supported by the strong defence industry and by pharmaceuticals and electronics. The purchasing managers' index for manufacturing[7] rose again in April and corporate sentiment remains good. Industrial output in Finland has been growing noticeably since the end of last year, especially in mechanical engineering and shipbuilding and in the defence industry. Large data centres and infrastructure projects are also supporting the construction sector in Finland. Growth in yearly industrial output in Latvia has also picked up in recent months, especially through increased production of chemical products, while growth in industrial output in Lithuania came from mining.

**The exporting sectors of Estonia's neighbours are also performing quite well.** Growth in exports from Sweden has been relatively stable (see Figure 11), but the appreciation of the Swedish krona has been some hindrance to exports. The main contributors to the strong growth in exports from Latvia have been mineral fuels and oil products. Growth in exports from Lithuania was supported above all in March by increased exports of fertilisers, but exports of services have lately been growing faster there than exports of goods. Export orders for Finland have increased in recent months, indicating that exports will continue to grow in the near future.

**Growth rates for consumer spending and retail sales have been quite resilient in Estonia's neighbours.** This has been supported by the continuing rise in real incomes. Consumption in Lithuania has been supported primarily by the money withdrawn during the pension reform that has helped households cope better with higher energy prices[8]. Increased public sector spending and tax cuts have given the economy in Sweden a boost. Higher energy prices and interest rates could however start to affect consumer confidence and purchasing power in Estonia's trading partners more and more as the year goes on.

Figure 12. HICP inflation of trading partners




Source: Eurostat

**There are wide differences in the rates of inflation in Estonia's trading partners.** Price pressures in Sweden have remained very weak and inflation fell further in April to 0.5% as food prices came down[9] (see Figure 12). The Swedish

7 Sweden's Swedbank Manufacturing PMI.

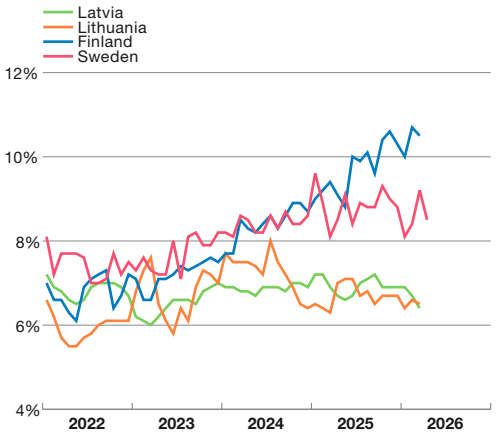
8 Around 40% of the funds had been withdrawn from the second pension pillar by April 2026.

9 VAT on food was cut in Sweden this year.

central bank consequently kept its base interest rate unchanged. Inflation in Finland meanwhile has risen from a very low level at the start of the year to 2.4%, mainly because of higher prices for electricity and fuel, and increased transport costs. Annual inflation in Latvia and Lithuania in April was notably higher at 2.9% in Latvia and 4.9% in Lithuania. High energy prices were again the main cause of inflation in those countries.

**There is equally a lot of variation between labour markets across the countries.** Unemployment remains high at 11% in Finland and 9% in Sweden (see Figure 13) and consumer confidence remains weak and so the housing markets, among others, in both countries continue to perform poorly. If higher inflation causes interest rates to rise again, the recovery in the housing market may be delayed even further. A major concern in Finland is the high rate of youth unemployment, which has been made worse by the poor performance of the economy and the rigidity in the labour market. Unemployment rates in Latvia and Lithuania are clearly lower at 7-8%. Wage growth in both countries is slowing, but disposable income continues to increase faster than prices. This improves the consumption options of households and the growth in the economy more broadly.

Figure 13. Unemployment rates of trading partners




Source: Eurostat

# THE ESTONIAN ECONOMY

## ECONOMIC ACTIVITY

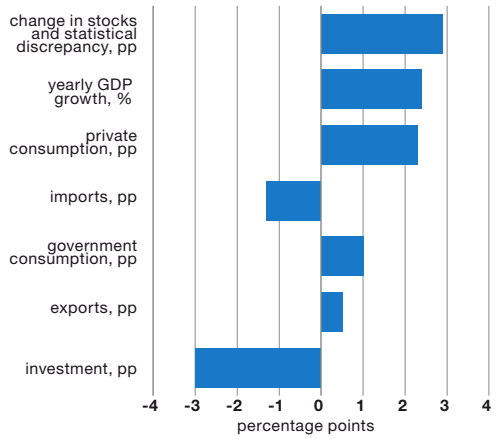
**The Estonian economy grew in the first quarter of 2026 largely with backing from a fiscal stimulus.** Growth was further supported by the economic environment being more favourable than in recent years, as interest rates were lower than a couple of years ago, inflation has come down, and no new tax rises have been introduced. The negative impact of the war in Iran was not yet particularly evident in the Estonian economy in the first quarter.

**Consumption led GDP growth in the first quarter as purchasing power was increased by changes to the personal income tax system.** The contribution of private consumption to growth in the economy was almost as large as total growth in the economy (see Figure 14). GDP grew by 2.4% over the year and by 1.1% from the previous quarter. Inventories and the statistical discrepancy made a strongly negative contribution to economic growth in the fourth quarter of 2025, but a very positive one in first quarter of 2026. Inventories making a large contribution could indicate that data limitations mean that the impact on economic growth of other components like investment could be underestimated.

**The data on the industrial sector for the first quarter were quite contradictory.** The output index for manufacturing fell in January to where it was in September and October 2025, and remained there in February, March and April. The sluggish performance of industry is confirmed by the moderate growth in exports of goods in the national accounts, as the total amount of goods exported was essentially unchanged over the year. At the same time though, the national accounts data show strong growth in manufacturing (see Figure 15).

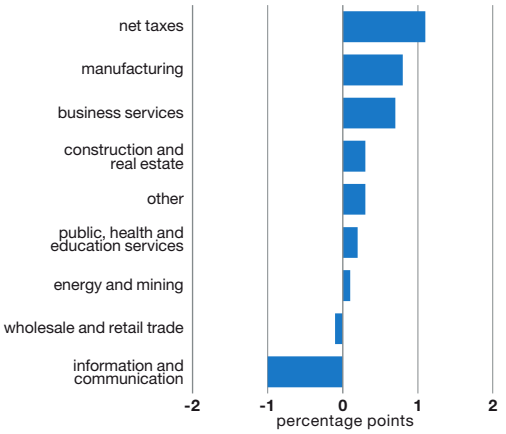
**A notable feature of GDP growth in the first quarter from the perspective of economic activities was the large contribution of net product taxes.** One reason for this was the rise in VAT in the middle of 2025. The contribution of net product taxes does not mean that GDP would have increased in accounting terms because of taxes, but rather reflects the distribution of income in the economy, as value added continues to be created by companies and workers. Higher tax rates meant that a larger part of the value added created is expressed as tax receipts than before. Despite tax revenues rising sharply, the financial results of non-financial companies in the first quarter show profits recovering rapidly, which is not yet fully reflected in the national accounts data.

Figure 14. Contributions to GDP growth in Q1 2026




Sources: Statistics Estonia, Eesti Pank

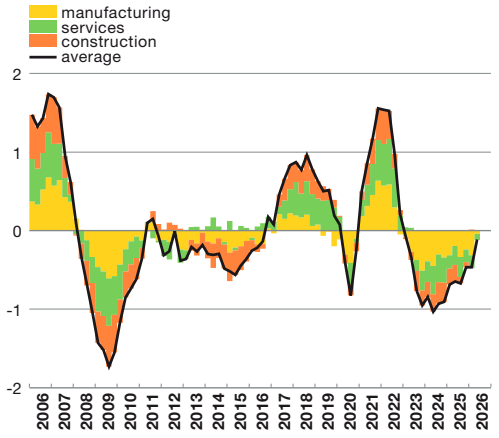
Figure 15. Contributions to GDP growth by sector in Q1 2026




Sources: Statistics Estonia, Eesti Pank

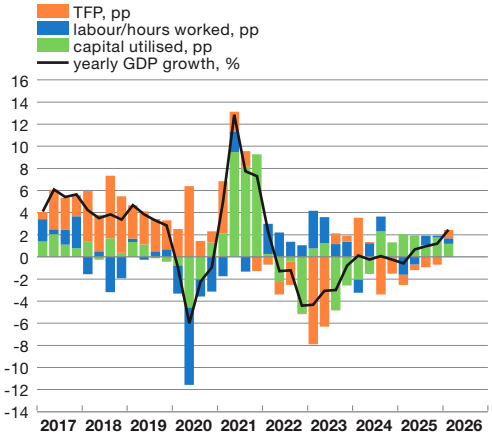
**A range of indicators and survey-based business-cycle assessments confirm the improvement in economic conditions.** The share of companies that consider weak demand to be the main obstacle to increasing production has declined (see Figure 16). This indicator was quite close to its long-term average by the start of the second quarter, though the rapid improvement in it may partly be a consequence of the war in Iran. Supply disruptions have become a greater

Figure 16. Standardised survey indicators of the business cycle



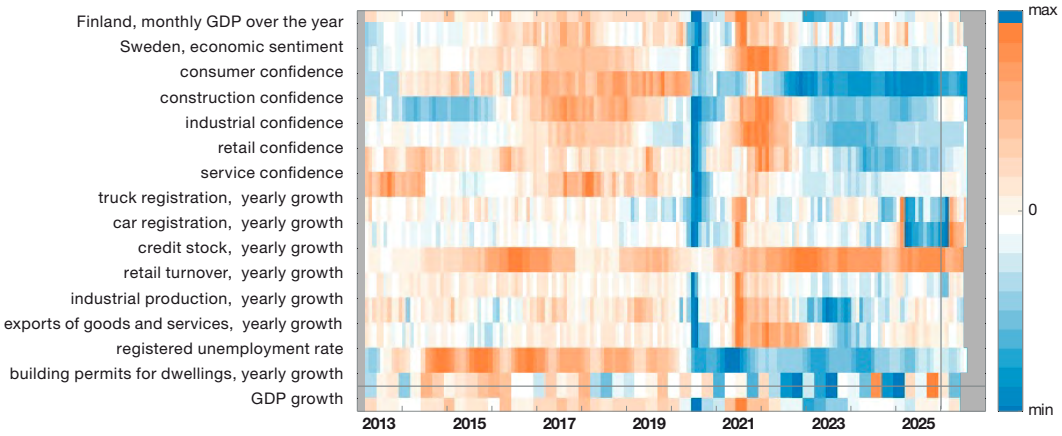

Sources: European Commission, Eesti Pank

Figure 17. GDP growth decomposed from the production function




Source: Eesti Pank

Figure 18. Heatmap of the Estonian economy




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

constraint for some firms, meaning that weak demand is no longer viewed as the primary obstacle to growth for them.

**The growth in total factor productivity also recovered in the first quarter.** Productivity growth has been weak in the Estonian economy in recent years, and one reason for this may be that labour and production capacity have been maintained even as demand has been lacking. Companies have continued to invest, though there has been no corresponding increase in output following those investments. Investments have helped lay the ground for the next cycle of growth, but maintaining production capacity without employing it in full means that production has been less efficient. Figure 17 divides GDP growth between the contributions of capital and labour and the effect of total factor productivity. The estimate shows that total factor productivity increased in the first quarter meaning that the economy grew by more than may be understood by looking only at the increased use of capital and labour.

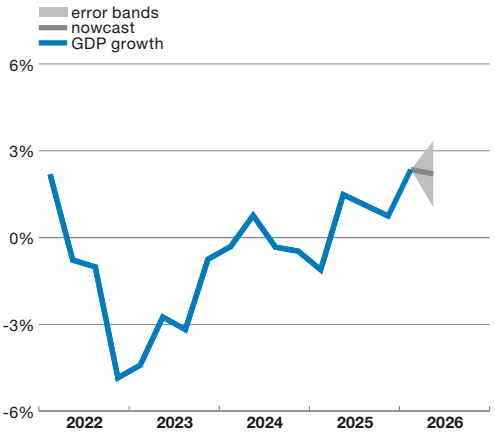
Box 2 looks in greater depth at the relatively low productivity in Estonia next to that in the Nordic countries and the other Baltic states.

**The heatmap for the second quarter is showing slightly warmer tones than that for the first quarter** (see Figure 18). The monthly proxies for GDP growth in Estonia's neighbours to the north showed positive growth over the year in April, indirectly indicating an improvement in foreign demand for Estonian exporters. Unemployment is also down and the banking sector continues to give strong support to the economy. Retail

trade volumes have increased since last year and confidence in the sector has improved. The latest sentiment survey for manufacturing is more positive than in the previous quarter, mainly because estimates for orders have improved[10].

The nowcast of economic growth in the second quarter based on monthly inputs[11] indicates that yearly GDP growth is of the same magnitude as in the first quarter (see Figure 19).

Figure 19. GDP growth and current quarter nowcast




Sources: Statistics Estonia, Eesti Pank

10 Statistics Estonia started compiling business and consumer surveys from May 2026 that measure the sentiment in four business sectors and among private consumers. The new values are not entirely comparable with the earlier data (see https://stat.ee/en/news/latest-business-and-consumer-survey-results-published-statistics-estonia), and the European Commission will not publish the seasonally adjusted values for Estonia for some time. The heatmap in Figure 18 uses an approximation, where the new unsmoothed values are adjusted by the seasonal coefficient from the same month of last year, which is the difference between the smoothed and unsmoothed series, and that is subtracted from the new unadjusted values.

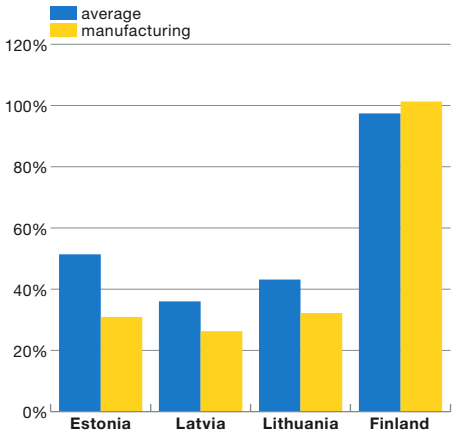
11 The nowcast produced by the Eesti Pank indicator models is a technical regression-based forecast that uses newly published monthly data. There are fifteen models in the set and the indicator forecast is the median of the individual forecasts. The uncertainty surrounding the forecast is represented by the average of the historical absolute errors of the current estimate.

## *Box 2: How productivity in Estonia compares with that in other Baltic and Nordic countries*

Estonian companies have more capital per employee than those in Latvia or Lithuania, but manufacturing in Estonia does not use that capital as intensively as in the other two Baltic states. Quite the contrary, because manufacturing in Estonia is more labour intensive than that in Latvia and Lithuania, and is a long way behind the Nordic countries in its capital intensity and productivity.

Economic processes are often described using the production function, which helps explain the structural sources of national economic development. This analysis uses the production function with constant returns to scale, which shows the dependence of value added on the three factors of labour, capital and total factor productivity. This gives an estimate of whether differences between countries come from the amount of capital deployed, the production technology used, or the capacity of companies to use resources efficiently. This box compares Estonia, Latvia, Lithuania and Finland with Sweden by sectors of GDP, because the Swedish economy is the most successful in the region.

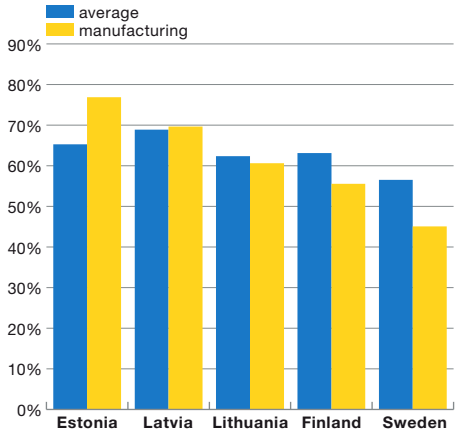
Figure B2.1. Productivity per hour worked, Sweden = 100%




Sources: Eurostat, Eesti Pank

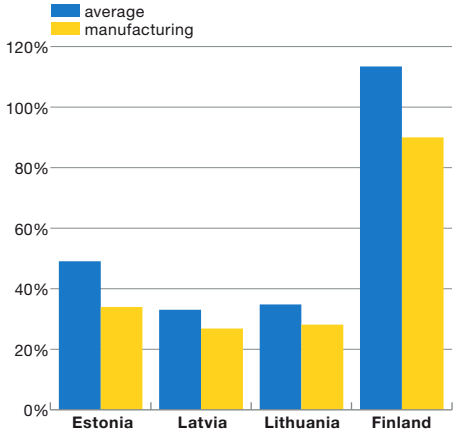
Estonian productivity per hour worked is around half that in the Nordic countries, but larger than in the other two Baltic states. Productivity in manufacturing is however relatively even further behind Finland and Sweden, and is also behind Lithuania (see Figure B2.1).

Figure B2.2. Labour share in the production function




Sources: Eurostat, Eesti Pank

Figure B2.3. Capital per hour worked, Sweden = 100%



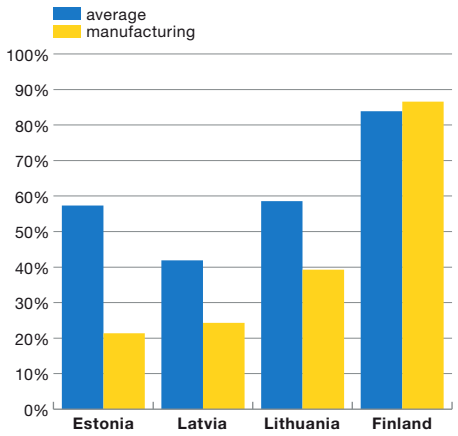

Sources: Eurostat, Eesti Pank

One way of increasing labour productivity is to replace human labour with machines. The Estonian economy as a whole is about as labour intensive as those in the other Baltic states and Finland, but more so than the Swedish economy (see Figure B2.2). Labour intensity is a measure of production technology, as it shows how much of the value added is created by labour and how much comes from capital. The services sector is usually more labour intensive, while industry, which uses machinery and equipment, is generally more capital intensive. Manufacturing in Estonia stands out particularly though for its unusually high level of labour intensity. Its production structure resembles that of a service sector more than that of a capital-intensive manufacturing sector.

The higher labour intensity than in Latvia and Lithuania is unlikely to result from poorer access to capital or a less favourable investment climate in Estonia. The Estonian tax system favours investment and investment as a share of the economy has been relatively large in international comparison. There is less capital per employee in manufacturing than there is in Finland and Sweden, but there is more than in Latvia and Lithuania (see Figure B2.3). Capital per employee in the economy as a whole is about half of that in Sweden, while in manufacturing it is only around a third of the level in Sweden.

In addition to labour and capital, total factor productivity (TFP) can be estimated with the production function. TFP measures value creation that cannot be explained solely by the amounts of labour and capital used. Higher TFP indicates that management is more efficient, technology is better, products are more complex, or that there are other competitive advantages. The TFP of the Estonian economy as a whole is a little below 60% of the level in Sweden (see Figure B2.4), but the gap in manufacturing is considerably wider as the Estonian figure is less than a quarter of the Swedish one and is smaller than those for Latvia and Lithuania.

Figure B2.4. TFP, Sweden = 100%




Sources: Eurostat, Eesti Pank

The high labour intensity and low TFP of Estonian manufacturing indicate that companies are mainly working in the lower value-added stages

of the production chain. The sector's lagging performance cannot be attributed solely to a lack of capital, as there is more capital per employee in Estonia than in the other Baltic states. Becoming more competitive cannot be achieved only by increasing investment, as it is necessary to move towards more complex products, processes and business models.

These calculations use data from 2024 on value added by sectors and data on the amount of capital from the end of 2023. These are the most recent data available. Using the data from 2019 on value added and from the end of 2018 on the amount of capital gives fairly similar results.

It should be remembered when interpreting the results though that the data used are at current prices and are not adjusted for differences in price levels between countries. The price level in Estonia is lower than those in the Nordic countries, which may mean that TFP in Estonia is underestimated to some degree. This effect is probably greater for sectors that focus on the domestic market, but it is smaller in manufacturing, where prices are largely shaped by the international market.

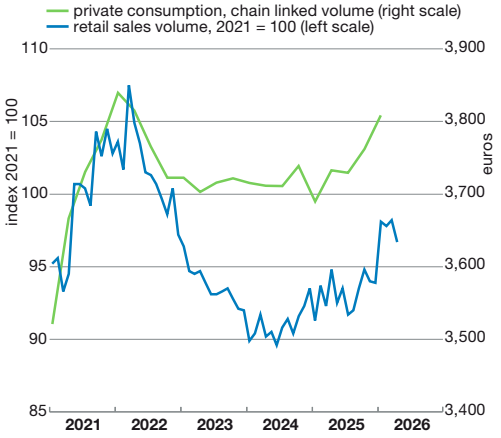
## DOMESTIC DEMAND

**The introduction of a uniform tax-free allowance meant households had more money available and helped to boost private consumption in the first quarter by 4.2% over the year.** Growth in private consumption was last faster than that during the recovery from the Covid-19 pandemic and when the money withdrawn from the second pension pillar was spent. The volume of private consumption still remained a little below its peak of 2022 (see Figure 20).

**Housing costs contributed a substantial part of the increase in consumption in the first quarter, as they were pushed up by the weather in January and February being colder than on average.** Higher energy costs meant that housing costs as a share of consumption reached a new historical record level. Households still had money left over for other spending after covering essential expenses however, and spending increased on leisure, home goods and vehicles among other things. Car sales recovered after the introduction of the registration tax last year, and private individuals registered 70% more new cars in the first quarter than in the same quarter of last year. The high rate of growth can clearly be partly explained by the low reference base from last year.

**Retail sales volumes have also been increased by drivers from neighbouring countries filling up with motor fuels in Estonia alongside Estonian private customers.** Retail

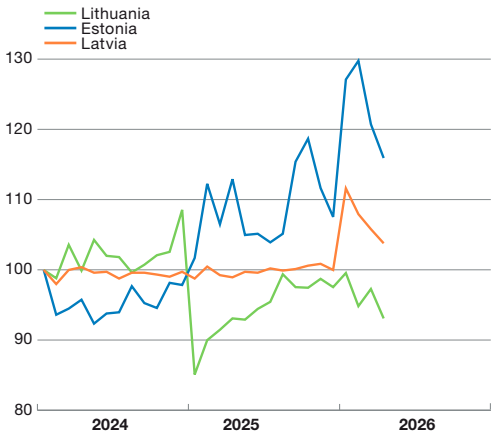
Figure 20. Private consumption and retail sales




Sources: Statistics Estonia, European Commission, Eesti Pank

growth was already gaining pace last year, mainly through sales of manufactured goods and fuels, and drivers from abroad have been coming into Estonia to fill up as well. Rises in excise in Latvia and Lithuania in early 2025 widened the difference between fuel prices in Estonia and those in the neighbouring countries to the south. Those differences widened further in autumn 2025, especially for diesel, as Estonian filling stations started to compete with one another by cutting prices. Cheaper fuel has encouraged large international trucking companies to fuel up in Estonia more, and this has increased sales of fuel in Estonian filling stations (see Figure 21). Estonian customers also bought more motor fuel in the second half of the first quarter as the war in the Middle East provoked fears of further rises in fuel prices.

Figure 21. Retail sales of fuel in Estonia, Latvia and Lithuania




Source: Eurostat

**The recovery of external and domestic demand has not yet led to stable and broadly based growth in corporate investment.** It remains volatile and fell at the start of the year by almost a fifth over the year and over the quarter. Corporate investment in construction continued to decline at the start of the year, indicating that there was still no need yet for large-scale expansion plans. The decline also reflected the modest level of investment activity in sectors where construction usually plays a larger part. Several large projects in the energy sector have been completed, and there remains sufficient available production capacity in manufacturing to meet increasing orders. A long-term trend of investment in intangible assets as the economy digitalises continued. The role of that type of investment increases in parallel with the increase in the share of various professional services in the economy.

**Transaction activity in the housing market has stabilised,** but fewer transactions with new residential space were made in the first months of the year than a year earlier. The number of transactions in the secondary market was up by 3% over the year in the first quarter, while the number in the primary market was down by 18%. There were 24% fewer permits for use for new residential space issued than in the first quarter of 2025, meaning that fewer new residential developments came to the market. Housing loans have continued to be issued at a rapid rate even as the transaction statistics are weak, and there has been a substantial increase in the share of transactions financed by borrowed money. The number of housing loans issued in the first four months of the year was 7% higher than a year earlier, and the growth in the housing loan stock has accelerated beyond 10%. The average interest margin has not particularly changed in the past 18 months and remains at close to 1.5%.

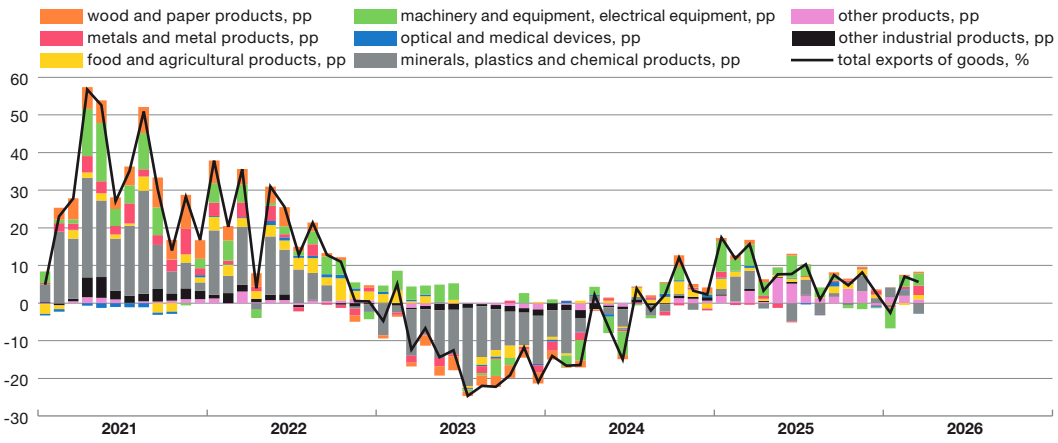
**Access to credit for companies and households was good at the start of the year.** This is shown by survey data and by the relatively fast growth in lending. The survey of lending activity of the banks indicates that conditions for corporate loans were eased a little in the first quarter. The interest margins on new long-term loans were around 0.4% lower in the first four months of the year than in 2025 on average, and this balanced out for new borrowers the effect of the rise in Euribor at the start of the year. The growth in the corporate loans portfolio picked up to 8.3% by the end of April, with the growth driven above all by real estate and construction and by agriculture. The growth in the loan portfolio for manufacturing reached around 7% at the same time, and the stock of loans to the trade sector ended its long decline.

**Corporate inventories increased overall in the first quarter,** while stocks of finished product decreased, indicating that demand had improved and it had become easier for manufacturers to find buyers for their goods. There was a notable increase in stocking up of inventories of raw materials and inputs in manufacturing, which can be linked to the improved outlook for new orders throughout the first quarter. Changes in inventories are usually very volatile and are steered by the expectations of companies for future demand and the availability of production inputs.

## EXTERNAL BALANCE AND COMPETITIVENESS

**Global trade was lively at the start of the year and demand in Estonia's main trading partners was improving.** The war that started between the USA and Iran at the end of February increased uncertainty though, and caused supply problems in goods markets while also restricting further growth in demand. The turnover of Estonia's foreign trade was 3% higher in first quarter than a year earlier as the turnover of exports of goods and services increased by 2% and that of imports by 4%.

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



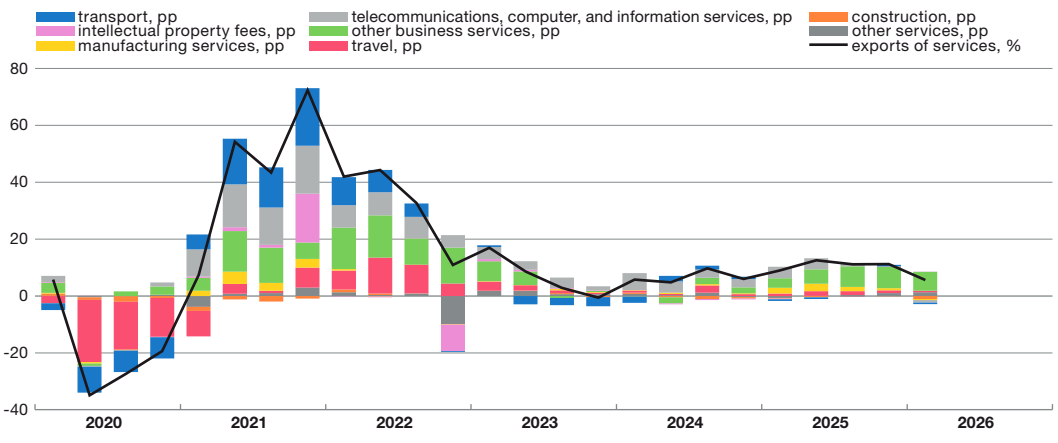

Source: Statistics Estonia

**The improvement in exports of goods was supported by increased sales above all in groups of goods related to manufacturing.** Major contributors to the increase in the turnover of exports were machinery and equipment, and metal products, and in March also mineral fuels (see Figure 22). The biggest increase in turnover of goods exports in the first quarter was in exports to Latvia and Sweden. The fastest growth in exports over the past 12 months on average though has been to Poland, Germany and Lithuania, where Estonian businesses have also increased their market share. The recovery in the Finnish market remains slow, but exports to it increased slowly at the start of the year. Data from the balance of payments indicate growth of 2% in exports of goods in the first quarter.

**Imports of goods meanwhile were affected in the first quarter by investment in national defence and increases in inventories, and by the revival of private consumption.** The turnover of imports of goods was 4% more in the first quarter than a year earlier, and the biggest contributors to the growth were imports of machinery and equipment, and of electronics. Goods imports have again been affected this year by purchases of capital goods for national defence. The growth over the year in the turnover of imports of services was below 1%, but was affected by the relatively high reference base in the same period of last year. Imports of business services are the largest part of services imports at a little over a third, while transport services and ICT services are each around a fifth.

**The growth in exports of business services has driven the growth in services exports for a long time.** The turnover of services exports was up by 4% in the first quarter and the growth

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




Source: Eesti Pank

was led by business services, which grew by 19%, while growth was also strong in exports of travel services at 5%. The turnover of exports of telecommunications and computer services fell though by 5% in the first quarter (see Figure 23), which was mainly because sales of computer services were down, and they are over 80% of the exports of ICT services. The turnover of exports of transport services was down by 3% in the first quarter, which came mostly from a drop in freight transport by road. The turnover of exports of maritime transport increased again by contrast, as it has for several consecutive quarters. Maritime transport accounts for about a quarter of exports of transport services, and road transport for a third.

**The balance of payments showed the current account was 148 million euros in deficit in the first quarter of 2026, or 1.4% of GDP.** This deficit was still smaller than that in the same quarter of last year though. The deficit on the goods account widened, but the increase in the surplus on the services account compensated for this (see Figure 24).

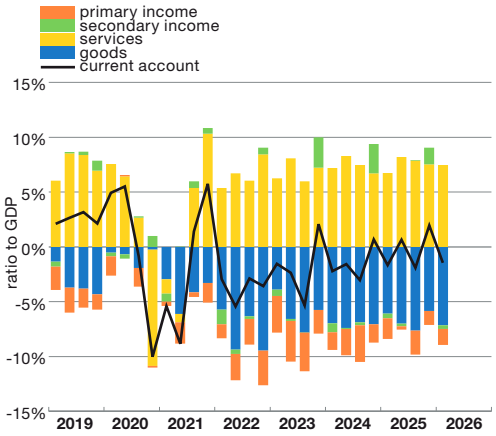
**Terms of trade remained at the same level in 2026 as at the end of last year, but the rapid rise in import prices in March and April caused some deterioration in them** (see Figure 25). Looking across sectors it becomes evident that some branches of the economy managed to pass on higher import costs into export prices. This was seen for metal and metal products for example, where import prices rose by 12% but the rise in export prices was even larger at 16%. A similar effect was seen with chemical products and production of coke and refined oil products.

**Corporate assessments of the outlook for competitiveness became more cautious in the second quarter, but were still more optimistic than a year earlier** (see Figure 26). The risk factors in the global economy were relatively balanced at the start of the year, but the outbreak of a new war increased uncertainty again and affects how competitive Estonian companies are through various price channels.

## THE LABOUR MARKET

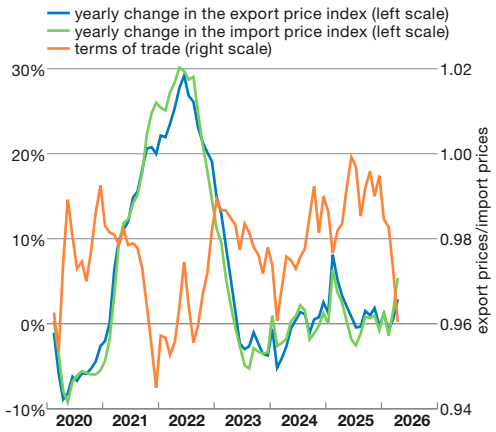
**There were no significant changes in the labour market in the first part of 2026.** The labour force survey showed that there were as many people employed at Estonian companies

Figure 24. Current account



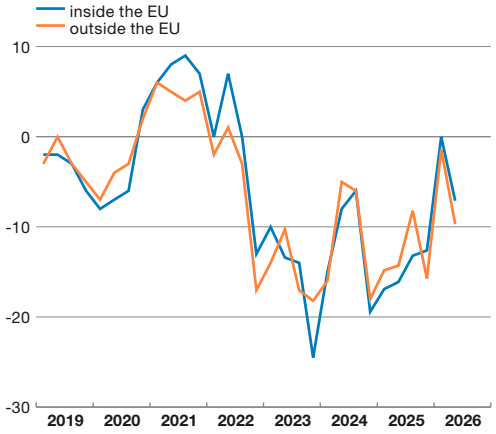

Sources: Statistics Estonia, Eesti Pank

Figure 25. Export and import price indexes



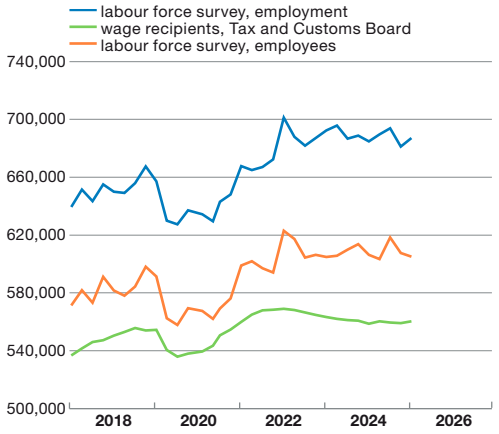

Sources: Statistics Estonia, Eesti Pank calculations

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



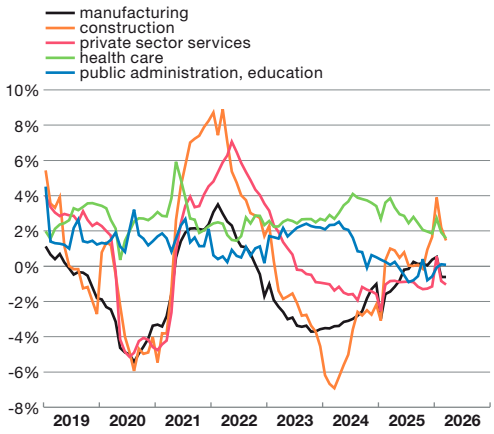

Source: European Commission

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




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

Figure 28. Yearly change in the number of declared wage recipients

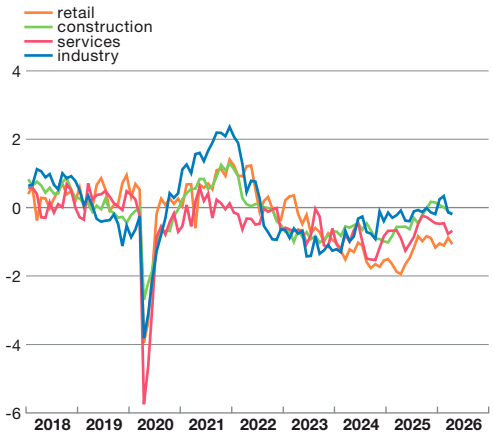



Sources: Tax and Customs Board, Eesti Pank calculations

and institutions in the first quarter of the year as there were in 2025 on average. Data from the Tax and Customs Board, which cover everybody declared as earning a wage, show that there were 0.3% more people receiving a wage under an employment contract in the first quarter than there were a year earlier (see Figure 27). Changes in employment in both the private and public sectors taken separately were modest in early 2026. There was a notable rise in the number of people receiving a wage in construction in the private sector (see Figure 28), which may have been driven by the work on Rail Baltic. The revival in manufacturing in the second half of 2025 proved only temporary though, and the number of waged employees there fell in early 2026. Employment continued to fall in the service sector. Growth in public sector employment was again led by healthcare, where there was a large jump in the number of employees.

**The increase in uncertainty coming from the external environment caused the preliminary indicators for employment to weaken.** Expectations of employers for employment, which have been well aligned with the actual trends in developments, fell in March in manufacturing and construction to a little below their historical average level, and remained below it in retail and services (see Figure 29). The number of jobs intermediated by Töötukassa started to rise at the end of 2025 and was 11.7% higher in the first quarter of 2026 than a year earlier, though the growth stopped in April. Construction made a large contribution to the rise in the number of vacancies and contributed over half of the increase in the past half year. The

Figure 29. Employment expectations, standardised

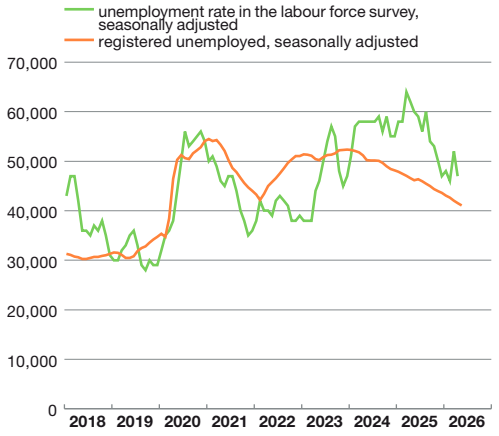



Sources: European Commission, Eesti Pank calculations

number of people earning a wage in manufacturing started to fall again, and the number of vacancies was also down by a fifth in the first quarter of 2026. A positive sign was the increase in the number of vacancies in retail.

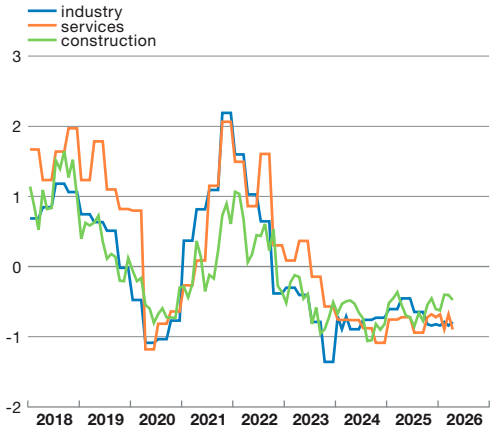
**Unemployment reached 7.1% in the first quarter, but the rise from 6.4% in the fourth quarter of 2025 can be explained by seasonal factors.** The average unemployment rate in February, March and April, which is an indicator that prefigures the second quarter of 2026, was very low at 6.3% (see Figure 30). The low labour participation rate has made some contribution to the fall in unemployment. The labour force participation rate shows the share of people of working age who are either working or actively looking for a job and are ready to start work within a short time. The labour force participation

Figure 30. Unemployment




Sources: Statistics Estonia, Töötukassa, Eesti Pank

Figure 31. Labour shortages, standardised



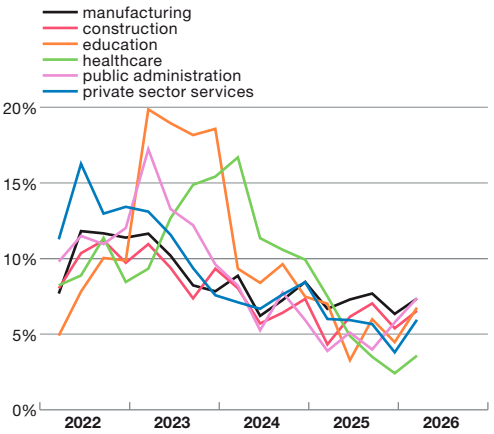

Sources: European Commission, Eesti Pank calculations

rate in Estonia remains one of the highest in the European Union despite falling. The number of people registered as unemployed continued the downward trajectory that it started on in 2024 and was 10.4% down over the year in the first four months of 2026. Employers are not feeling labour shortages more sharply than they were earlier despite unemployment falling. An exception to this is construction, where the rapid rise in vacancies has been accompanied by some indications of labour shortages (see Figure 31).

**The growth in the average wage accelerated to 6.2% in the first quarter of 2026 from 4.5% in the third quarter of 2025, and the average wage stood at 2135 euros** (see Figure 32). Exceptional factors affected the dynamics of wage growth because of the changes to the tax system in 2025 and 2026. If December 2025, when the increase was exceptionally small, and January 2026, when the increase was exceptionally large, are left aside, then wage growth was 6.3% in October and November, and in February and March it was 5.3%. The rise in the minimum wage was postponed to April, which helped slow the growth by restraining the rise in the lowest wages. Lower inflation meant that real gross monthly wages increased by 2.7% in the first quarter of 2026 (see Figure 33). The introduction of the uniform level for tax-free income in 2026 meant that the average net wage rose by an estimated 10.4%, and its purchasing power was 6.6% higher than a year earlier.

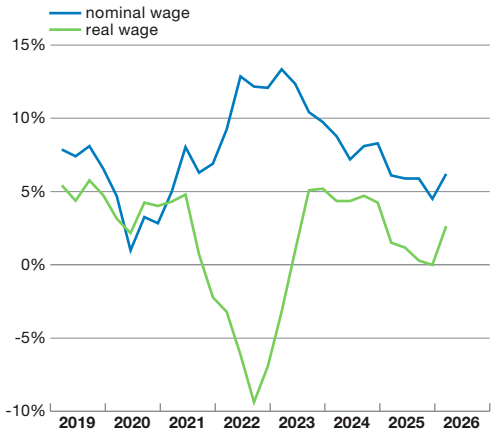
**The payroll grew in the first quarter of 2026 at the same rate as GDP at current prices,**

Figure 32. Yearly change in average wages



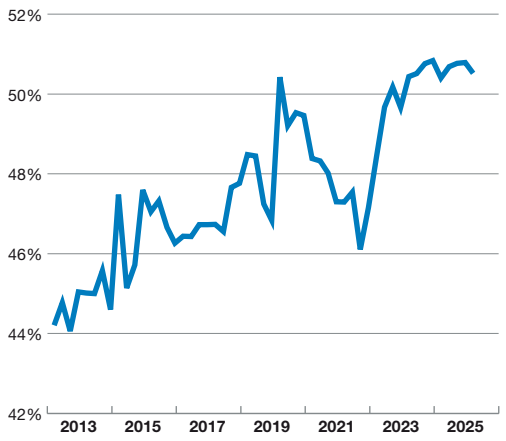

Sources: Statistics Estonia, Eesti Pank

Figure 33. Yearly change in average wages*



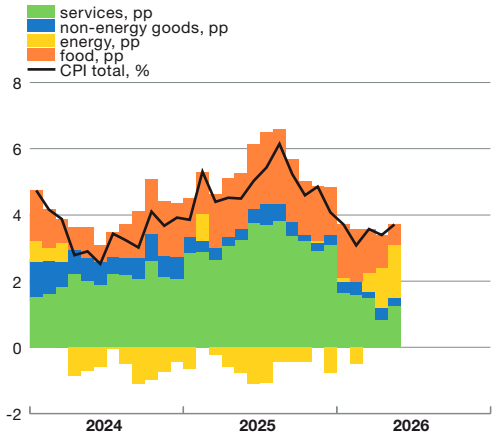

* Structural break in 2022; series for 2019-2021 adjusted by Eesti Pank
Sources: Statistics Estonia, Eesti Pank

Figure 34. The labour share in GDP, seasonally adjusted




Sources: Statistics Estonia, Eesti Pank calculations

Figure 35. CPI growth




Sources: Statistics Estonia, Eesti Pank

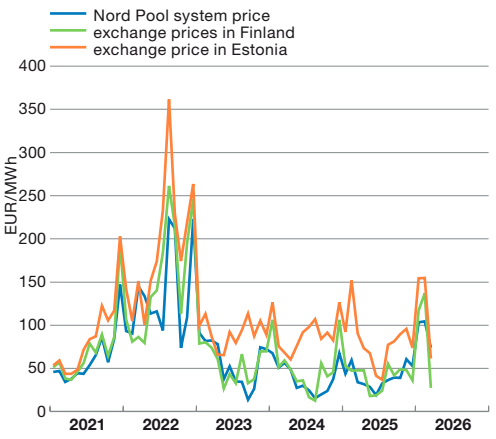
**and so pay as a ratio to GDP remained stable** (see Figure 34). The logic of the economic cycle is that employers hold onto their employees during a recession and so labour costs increase as a share of value added, and then as the economy starts to grow, production is first increased using the labour that is available, and so the labour share starts to decrease. Without the exceptional circumstances that increased both wage growth and the payroll at the start of the year, it is probable that labour costs would have started to shrink in this way in the first quarter of 2026.

## PRICES

**Prices rose moderately at the start of the year as inflation for services and food slowed, partially offsetting the impact of higher energy prices**. Consumer prices in April were 3.4% higher over the year, but inflation then picked up again to 3.7% in May (see Figure 35). Some 1.7 percentage points of inflation again came from earlier tax changes, but if that effect is left out then the inflation rate in Estonia was one of the lowest in the euro area.

**The crisis in the Middle East meant that prices for motor fuels started to rise in March and April.** The price of diesel fuel jumped particularly fast as supply difficulties caused refining margins to increase. The price of oil has fluctuated widely in recent months, swinging between 90 and 120 dollars a barrel. The exchange price of electricity fell at the start of spring, which offset a large part of the impact of the rise in prices of motor fuels (see Figure 36). The increase in energy prices has been relatively more narrowly based than it was in the crisis of 2022, as prices for gas and electricity temporarily leapt many times higher at the peak of that energy crisis.

Figure 36. Electricity exchange prices




Source: Nord Pool

**Inflation for food was high at the start of the year at 6% but has since come down quickly.** Lower prices on international markets for food commodities have already led producer prices and import prices for food to fall. Consumer prices for food have also been rising gradually more slowly in recent months, and were up by 2% in May. There was a notable drop at the start of the year in inflation for services, which was the main driver of total inflation last year. Inflation for services was restrained particularly by the impact of the vehicle tax passing out of the reference base. Prices for non-energy industrial goods did not particularly change over the year.

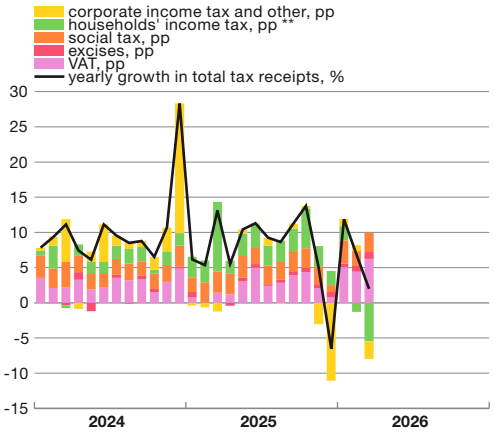
## GENERAL GOVERNMENT FINANCING

**The growth in tax revenues in the state budget varied widely across different taxes in the first quarter** (see Figure 37). Data from Statistics Estonia indicate that 7.0% more in total was received in tax than a year earlier. VAT did most to increase tax revenues as receipts of it were 19.4% larger than a year earlier. A large part of this increase came from the rise in the standard rate of VAT in July 2025 from 22% to 24%, but receipts increased by substantially more than can be explained by the rise in the tax rate alone. Receipts of VAT without the impact of the rise in the tax rate were around a tenth higher than they were at the same time last year. Receipts of fuel excise also jumped sharply and were 22.3% higher than a year earlier. Less was taken in receipts of tobacco and alcohol excise than a year earlier though, even though the rates of those excises rose at the start of the year. One reason for this was the usual stocking up that happens before tax rates rise, which caused excise receipts to increase at the end of last year.

**The growth in receipts of labour taxes slowed sharply in the first quarter.** This was mainly because of the change to the income tax system that came in at the start of the year and that applied a uniform level of tax-free income. Receipts of personal income tax were down by 7.9% on the first quarter of last year. They were reduced not only by the changes to the income tax system but also because there were more rebates of income tax paid in excess than there were last year. The impact of this is partly eased because some wage recipients, including a lot of those earning higher wages, did not use their tax-free income in the first quarter. Receipts of social tax were 6.1% higher in the first quarter than a year previously, indicating that developments in the labour market and wage growth continued to favour receipts of labour taxes. Corporate income tax received was 5.4% lower in the first quarter than a year earlier.

**The faster growth in final consumption expenditure by the general government in the first quarter was one source of GDP growth.** Final consumption expenditure by the general government was up by 9.1% over the year, which is a faster rate of growth than the average for last year. Higher wage costs and faster growth in intermediate consumption led the growth. Intermediate consumption by the general government covers goods and services that the state purchases in order to provide public services. These are the current operating expenses of the general government and do not include the wage costs of the government sector itself, social benefits, investment or interest expenses. The growth in intermediate consumption started to accelerate at the end of last year and spending on it was 12.0% higher in the first quarter than it was a year earlier.

Figure 37. Tax revenues in the state budget*




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

**Growth in the general government payroll also picked up in the first quarter.** Data from Statistics Estonia show the payroll increased by 7.4% over the year. A lot of this came from pay rises in national defence, education and internal security. Wage rises in healthcare, which is also a very labour-intensive area, were smaller in the first quarter because the wage rise last April that was agreed in the collective agreement averaged only 1.5%. A larger wage rise averaging 5% came in this April though.

**The growth in general government investment was modest in the first quarter.** It increased by 2.3%, or about 11 million euros, over the year and the development across types of investment asset was quite uneven. Investment in construction was up 4.3% over the year in a reversal from the second half of last year, when it was falling. This probably came from the increase in investment in construction for rail and road transport. Investment in intellectual property also contributed to the growth and was up by a tenth over the year. This investment included spending on research and development work and on buying or developing software and databases. Investment in machinery and equipment was down by 8.7% at the same time, and investments were also decreasing in transport vehicles and in other machinery and defence equipment.

# THE EESTI PANK ECONOMIC FORECAST FOR 2026-2028

*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 March 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 consistency 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

**Moderate growth will continue in the global economy, but at a slower rate than before.** The International Monetary Fund (IMF) forecasts that growth in the global economy in 2026 will be 3.1%, and that it will be 3.2% in 2027. This is less than was earlier expected, mainly because of the negative impact of the war in the Middle East[12]. The IMF forecast assumes that the conflict will be short lived and that disruptions to energy markets and supply chains will ease by the middle of 2026. The OECD has a similarly cautious outlook[13] and it estimates that the global economy has so far shown signs of being able to adapt, though the disruptions to energy markets are increasing risks. The global economy continues to get support from high levels of investment activity, especially in technology, relatively favourable financing conditions, and adjustments in trade in response to changing geopolitical circumstances. The recent disruptions to energy markets and increased uncertainty have however made the outlook for economic growth worse.

**If the war in the Middle East does not last long, it will probably have only a limited impact on the global economy.** How long the conflict will last is hard to forecast though, and so the IMF has produced two risk scenarios. In the less severe scenario, the oil price averages around 100 dollars a barrel this year and then falls to 75 dollars in 2027. This rise in prices pushes inflation up and makes financing conditions a bit tighter, with the result that growth in the global economy slows to 2.5% in 2026. Higher energy costs and increased price pressures reduce consumption and limit people's purchasing power, but growth in the global economy still picks up to 3% in 2027.

**In the more negative scenario, the conflict drags on for longer and has a serious impact on the global economy.** Growth in the global economy is restrained above all by the oil price remaining at 100–120 dollars a barrel in 2026-2027, higher prices passing through into the economy more broadly, disruptions in the energy market making commodity shortages worse, demand weakening in the private sector, and financing conditions deteriorating. The combined impact of these factors is to slow growth in the global economy to around 2% in 2026 and 2027 as inflation rises to around 6%. The impact of the energy crisis will be felt most acutely in emerging economies that import energy like India, Turkey and Egypt, where heavy dependency on imports of oil and gas will increase pressure on the balance of payments, the exchange rate, and inflation. The advanced economies that will feel the impact most are those where higher energy prices affect the price level and economic growth more broadly, like Germany, Italy and the United Kingdom.

**Growth in the largest economies will mainly slow in the years ahead.** The US economy will grow by 2.3% in 2026 with support from fiscal policy and from earlier loosening of monetary policy. Growth will be reined in at the same time though by trade restrictions and the slow development of the labour market[14]. The economy will grow by 2.1% in 2027 thanks to tax cuts and investment in technology, which will be counterbalanced by lower inflation and

12 IMF World Economic Outlook (April 2026), Global Economy in the Shadow of War.

13 OECD Economic Outlook, Interim Report (March 2026), Testing Resilience.

14 IMF World Economic Outlook (April 2026), Global Economy in the Shadow of War.

slower growth in consumption. Weaker foreign demand and the conflict in the Middle East will cause growth in the Japanese economy to slow to 0.7% in 2026 and 0.6% in 2027. Growth in the Chinese economy will remain moderate at 4.4% in 2026 and 4.0% in 2027, and will be held back by weakness in the real estate sector and modest growth in domestic demand. Growth will depend largely on how energy prices develop and on the ability to adjust to new geopolitical circumstances, including investment in energy efficiency and alternative sources of energy.

**Tensions in energy markets could cause global inflation pressures to increase again.** The IMF forecasts that global inflation will rise to 4.4% in 2026 and then fall back to 3.7% in 2027. The OECD also observes that the disruptions in energy markets caused by the war in the Middle East emerged at a time when inflation had not yet reached the target levels set by central banks in several countries. This could encourage inflation pressures. The use of strategic energy reserves has helped ward off a steeper rise in the oil price, but energy prices remaining high for a long time could raise expectations for inflation and increase the probability of central banks needing to start raising base interest rates.

### The euro area

**War in the Middle East and the consequent rise in energy prices have caused growth in the euro area economy to slow.** Growth was still supported in the first quarter by the broadly based revival of economic activity at the start of the year, and the performance of both services and manufacturing improved in the first months of the year, when consumer spending also increased. The situation in the Middle East and higher energy prices have however caused confidence among both consumers and companies to fall sharply in more recent months. Growth is consequently expected to slow in the euro area economy and inflation to rise. How the war impacts economic growth and inflation moving forwards depends largely on how long it lasts and how it affects global trade and supply chains. The economy will continue to get support moving forwards from increased investment in defence, energy and infrastructure, which should start to show a positive impact in the second half of this year. The latest forecast from the Eurosystem consequently expects that euro area GDP will grow by 0.8% this year, 1.2% in 2027, and 1.5% in 2028.

**Inflation is slowly rising in the euro area.** Several surveys indicate prices are rising already for energy, commodities and other production inputs, which will make businesses and consumers in the euro area more cautious. There is a danger of companies starting to reduce their own investments and postponing expansion plans, and of consumers choosing to save rather than to spend. If the cost of borrowing rises and the real incomes of households fall, the support that consumers give the euro area economy will decline. Unemployment in the euro area remains close to its historical lowest level however, and companies have sufficient buffers to survive more difficult times. Corporate surveys in the euro area confirm that companies have managed to mitigate the risks of increased energy costs better than they did in 2022 when Russia launched its full-scale invasion of Ukraine. The Eurosystem forecast consequently expects that inflation in the euro area will be 3.0% this year, 2.3% in 2027, and 2.0% in 2028.

## TECHNICAL ASSUMPTIONS USED IN THE FORECAST

### Assumptions for the external economy

**The external environment remains uncertain and how events unfold around the world could cause substantial changes in it.** The assumptions for the external environment used in this forecast are based on those in the June forecast of the European System of Central Banks, which showed the most probable directions of development at the point they were fixed on 21 May. Geopolitical developments may however substantially change the outlooks for commodity, capital, currency and money markets, and also the other binding assumptions, and that would have a substantial impact on the performance of the Estonian economy. The situation in the Middle East and the price of energy, including oil, affect the economic climate broadly but unpredictably. Box 3 consequently discusses possible alternative scenarios for development for the Estonian economy.

**Higher energy prices will raise production costs and drive inflation up.** The war in Iran has raised the oil price a long way and when the external assumptions were fixed on 21 May, future transactions were indicating an average oil price this year of 96.9 dollars a barrel, which is a notably

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

| | | | | | *March 2026 projection* | | |
|---|---|---|---|---|---|---|---|
| | **2025** | **2026** | **2027** | **2028** | **2026** | **2027** | **2028** |
| Foreign demand growth (%) [2)] | 4.1 | 2.5 | 2.7 | 3.3 | 3.4 | 2.8 | 3.1 |
| USD/EUR exchange rate | 1.129 | 1.169 | 1.168 | 1.168 | 1.162 | 1.159 | 1.159 |
| Interest rate (three-month EURIBOR, %) | 2.2 | 2.4 | 2.8 | 2.7 | 2.3 | 2.6 | 2.6 |
| Oil price (USD/barrel) | 69.1 | 96.9 | 82.2 | 77.1 | 81.3 | 72.1 | 70.2 |
| Price growth for food commodities (EUR, %) [3)] | 4.1 | -0.4 | 2.9 | -0.2 | -1.8 | 2.1 | 0.5 |

1) Cut off date of technical assumptions is 21 May 2026 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**

| | **2026** | **2027** | **2028** |
|---|---|---|---|
| Government sector GFCF (EUR billion) | 3.5 | 3.4 | 3.1 |
| Government sector intermediate consumption (EUR billion) | 3.0 | 3.1 | 3.4 |
| Government sector non-tax revenues (EUR billion) | 2.8 | 2.5 | 2.5 |

Source: Ministry of Finance

higher level than markets were expecting when the March forecast was written. The updated assumptions put the price of crude at close to 82 dollars a barrel in 2027 and then 77 dollars in 2028 (see Table 2).

**Demand is expected to grow in Estonia's main export markets, but a little more slowly this year than was earlier forecast.** The average growth in demand in the most important export markets for Estonia will be 2.5% this year, which is 0.9 percentage point slower than in the previous forecast. Growth in foreign demand will be around 2.7% in 2027 and 3.3% in 2028, which is the same magnitude as the average rate of the past decade. The outlook for the Swedish and Lithuanian economies is a little better than that for other trading partners. The Swedish economy will get an additional boost from increased fiscal spending and tax cuts, while the reform of the second pension pillar will release money in Lithuania, which will also benefit from its close connections to the strong Polish economy.

**The additional inflation pressures coming from higher energy and fuel prices have increased the expectation that interest rates will remain at a higher level.** Future transactions in the money markets indicate that the three-month Euribor will average 2.4% this year, which is 0.1 percentage point higher than in the previous forecast. The money markets expect the three-month Euribor to be 2.8% in 2027, which is 0.2 percentage point higher than was assumed in the previous forecast. Future transactions suggest that the interest rate may fall a little in 2028 (see Table 2). It should be remembered though that monetary policy decisions and the rate of Euribor in future will depend on the progress of the euro area economy and the outlook for inflation, which is currently highly uncertain because of the geopolitical circumstances.

## Assumptions for general government financing

**The assumptions for tax policy cover all the tax changes that have been passed.** A new assumption in the forecast is that some wage recipients will not use the tax-free income allowance throughout 2026. This will increase tax revenues this year, but lead to rebates next year for excess income tax paid.

**The forecast for the state finances also takes account of the spring economic forecast of the Ministry of Finance for investment, intermediate consumption, and non-tax revenues** (see Table 3). 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 5% of GDP this year and 5.4% in 2027.

# ECONOMIC GROWTH

**Fiscal policy will give a powerful boost to economic growth in the near term.** GDP will grow by 2.4% in 2026, and the main driver will be

the changes to the personal income tax system. The tax changes will directly stimulate domestic demand and so the branches of the economy that are focused on the domestic market (see key indicators for the forecast in Table 4 and comparison with forecasts by other institutions in Table 5). The problems that the economy has faced in recent years, like high interest rates and inflation and weak demand in trading partners, have eased and so the chance for growth has improved.

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

| | 2024 | 2025 | 2026 | 2027 | 2028 |
|---|---|---|---|---|---|
| Nominal GDP (EUR billion) | 39.83 | 41.61 | 44.14 | 46.58 | 48.87 |
| GDP volume [2)] | -0.1 | 0.5 | 2.4 | 2.5 | 2.4 |
| Private consumption expenditures | 0.2 | 0.0 | 4.1 | 2.8 | 2.2 |
| Government consumption expenditures [3)] | 1.8 | 2.5 | 3.5 | 0.8 | 1.8 |
| Gross fixed capital formation | -6.1 | 3.0 | 8.7 | 2.0 | -0.4 |
| Exports | -1.5 | 4.9 | 3.0 | 2.4 | 3.5 |
| Imports | 0.2 | 5.1 | 5.6 | 2.3 | 2.8 |
| Output gap (% of potential GDP) | -4.1 | -4.2 | -2.8 | -1.8 | -1.2 |
| | | | | | |
| CPI | 3.5 | 4.8 | 3.4 | 2.6 | 2.3 |
| HICP | 3.7 | 4.8 | 3.4 | 2.7 | 2.3 |
| GDP deflator | 4.0 | 3.9 | 3.6 | 2.9 | 2.4 |
| | | | | | |
| Unemployment rate (% of the labour force) | 7.6 | 7.5 | 6.5 | 6.4 | 6.3 |
| Employment [4)] | 0.2 | -0.5 | 0.1 | 0.0 | 0.0 |
| Average gross wage (EUR) | 1981 | 2092 | 2216 | 2322 | 2428 |
| Average gross wage growth | 8.1 | 5.6 | 5.9 | 4.8 | 4.6 |
| Median gross wage (EUR) | 1628 | 1724 | 1833 | 1925 | 2017 |
| Median gross wage | 8.5 | 5.9 | 6.3 | 5.0 | 4.8 |
| GDP per employee | -0.3 | 1.0 | 2.3 | 2.5 | 2.4 |
| | | | | | |
| Current account (% of GDP) | -1.3 | -0.2 | -3.4 | -3.1 | -2.5 |
| | | | | | |
| Budget balance (% of GDP) | -1.1 | -2.0 | -4.2 | -4.9 | -4.2 |

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 | 0.5 | 2.4 | 2.5 | 2.4 | 3.5<br>3.7* | 4.8<br>4.8* | 3.4<br>3.4* | 2.6<br>2.7* | 2.3<br>2.3* |
| Ministry of Finance | -0.1 | 0.6 | 2.3 | 2.5 | 2.3 | 3.5<br>3.7* | 4.8<br>4.8* | 4.0<br>4.0* | 2.7<br>2.7* | 2.2<br>2.3* |
| European Commission | -0.1 | 0.6 | 1.6 | 1.7 | | 3.7* | 4.8* | 4.4* | 2.9* | |
| IMF | -0.1 | 0.6 | 1.4 | 1.9 | 2.3 | 3.7* | 4.8* | 3.8* | 3.0* | 2.8* |
| OECD | -0.1 | 0.5 | 1.8 | 2.7 | | 3.7* | 4.8* | 4.1* | 2.6* | |
| Consensus Economics | -0.1 | 0.6 | 2.0 | 2.6 | | 3.5 | 4.8 | 3.8 | 2.8 | |
| Luminor | -0.1 | 0.5 | 2.0 | 3.0 | 3.0 | 3.5 | 4.8 | 3.0 | 2.0 | 3.0 |
| SEB | -0.1 | 0.6 | 2.5 | 2.7 | | 3.7* | 4.8* | 3.5* | 2.4* | |
| Swedbank | -0.1 | 0.6 | 2.0 | 2.5 | | 3.5 | 4.8 | 4.3 | 2.9 | |

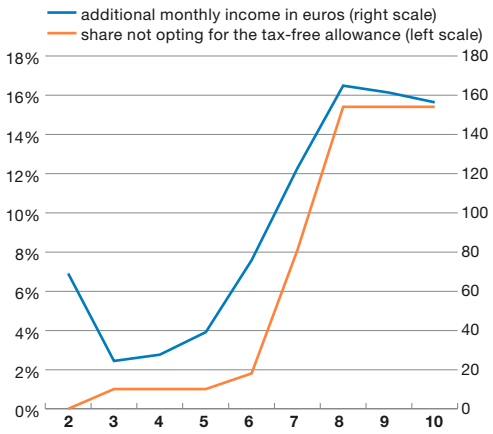
* HICP
Sources: Eesti Pank, June forecast, 16.06.2026; MoF, Spring 2026 forecast, 02.04.2026; European Commission. European Economic Forecast. Spring 2026, 21.05.2026; IMF, WEO, April 2026, 13.04.2026; OECD, Economic Outlook, Volume 2026 Issue 1, 03.06.2026; Consensus Economics, Eastern Europe Consensus Forecasts, May 2026, 18.05.2026; Luminor forecast, 18.03.2026; SEB, Nordic Outlook, May 2026, 05.05.2026; Swedbank Economic Outlook, 04.05.2026

**Demand recovering and companies bringing into use their spare production capacity will revive the economy in the coming years as well.** That there is spare production capacity is shown by the estimated negative output gap and by survey-based indicators of the business cycle. Surveys show that production potential in manufacturing is still being used less than it was earlier on average. There are however fewer companies in various sectors than in earlier years whose activities are limited by labour shortages, and relatively more that are hampered by insufficient demand. Underused resources being put to work will allow the economy to grow by around 2.5% a year in 2027 and 2028.

**The economic recovery will rely on productivity, and employment will not notably rise.** The output of the total economy can be increased without additional workers because jobs were not eliminated during the recession to the same extent that output fell. The number of people working in sectors that are recovering rapidly could however rise, while it falls in sectors that are struggling. Although the total number of people in employment will not rise, the share of the shrinking population of working age that is in employment will increase, and unemployment will fall. This means that it will become easier for jobseekers to find employment.

**Wage growth will be around 6% this year, but will then fall to 4-5%.** Wages will rise a little faster this year than in 2025 because of the changes to the tax system. The rise in the income tax rate in 2025 nudged some companies to bring their wage payments forward and shift them into 2024. The introduction of uniform tax-free income by contrast encouraged wage payments from the end of 2025 to be postponed into early 2026. Growth in wages would have been faster last year without these factors, and it slowed this year. The changes to income tax this year have seen the average income tax rate fall and net wages increase, easing the pressure a little on employers to raise gross wages. The rise in the minimum wage this year has had less impact than usual, as it only applied from 1 April and the wages of a lot of low-paid employees were not raised in the first quarter. Public sector wages will increase substantially faster in 2026 thanks to collective agreements, but this will follow unusually small pay rises in 2025.

Figure 38. Use of tax-free allowance by income deciles




Sources: Tax and Customs Board, Eesti Pank

**Private consumption, having been stalled for several years, will be encouraged this year by the introduction of the uniform tax-free allowance.** The single threshold of 700 euros for tax-free income will increase the net incomes of households and improve their ability to consume. Colder weather than usual in the first quarter increased spending on housing noticeably, but other spending also grew strongly on top of spending on essentials. This indicates that households are ready to use the additional income from the tax changes to increase consumption, which has been quite modest in recent years.

**Some of the fiscal stimulus directed at households this year will be pushed back to next year, as around 17% of employees earning a wage have currently not used their tax-free income.** The share of those who have not used their tax-free income is larger in the upper income deciles, whose additional income from the tax cuts would have been the maximum possible of around 150 euros a month (see Figure 38). As a result, households will pay around 100 million euros in excess income tax this year, and the tax change will increase their disposable income by around 600 million euros rather than 700 million. The state will however return the excess income tax paid this year as a one-off payment next spring. As this one-off tax repayment will be smaller than monthly wages, it is likely that this money will largely be used for consumption next year.

**Businesses will buy production capacity to meet increasing demand and remain competitive.** Production capacity utilisation at

manufacturing companies has increased rapidly in recent quarters, and there is an increasing need to invest in expanding production. The survey of manufacturing by Swedbank finds that the main aim of investment is for companies to increase their efficiency while remaining competitive despite rapid wage growth and relatively high energy prices. Digitalisation and the wider spread of artificial intelligence will increase spending on intangible assets, whether that is licences or capitalised labour costs. Corporate investment plans will again be hindered by increased geopolitical uncertainty and a lack of clarity about the future development of energy prices.

**The good capacity of the banks to lend and tight competition between them will mean that access to finance stays good throughout the forecast horizon.** Demand for loans remaining moderate will mean that competition between the banks that are looking to grow will be the toughest it has been in the past decade for housing loans and corporate loans.

**Increased demand from abroad will revive exports.** Exporting companies assess that they have generally become more competitive in the past two years and that this trend is likely to continue in future. Manufacturing output recovering will increase goods exports this year and in the years ahead. Countries in Central Europe, particularly Germany, Poland and Lithuania, will become increasingly important target markets for Estonia. Poland has benefited particularly from nearshoring, and is becoming an important centre of production in Europe. Exports from Estonia have increased their market share in those countries in the past year. Exports of goods to Sweden and Norway are also trending upwards. The contribution of the Finnish market will remain weak this year, but the outlook for growth there will improve in the years ahead. Growth in exports of services will again be encouraged by strong demand for ICT services and business services.

**Imports of goods will be affected this year by general government investment in national defence and an increase in defence equipment. Imports of goods and services will grow by 5.6% this year.** Additional imports in 2026 will cause the deficit on the current account to widen. Additional spending on defence this year will increase imports by an estimated 400 million euros or so, and consequently the current account deficit this year will be larger by 0.8 percentage point of GDP. The impact on the current account will be smaller in subsequent years.

## PRICES

**Inflation expectations have come down in recent months and inflation may come down further during the summer.** It will average 3.4% for the year this year, with the part of it that comes from tax rises fading over the following months. Without the tax rises inflation this year would be 2.4%. Core inflation, which is inflation without food and energy, will remain low this year, but the introduction of the uniform tax-free allowance will create some demand-side price pressures. The forecast for prices in 2027 is shaped by the expectation that energy prices will fall, but the reference base for food and services prices this year being low will also have an effect.

**The main source of inflation this year will be energy.** Overall inflation will start to pick up in the second half of the year, as higher energy prices will pass through into the prices of other goods and services. Inflation for food will be reined back by prices for several imports being lower than before on global markets. Higher prices for fertilisers and production costs rising will however pass through into food prices with a lag at the end of the year. Inflation has dropped sharply for services in recent months, and prices for services will rise by an average of around 3% in 2026. Services prices are affected very much by administrative decisions, including those that affect the transport sector and the introduction of European Union climate measures. Inflation for manufactured goods could increase in the years ahead as prices rise for electronic components because of strong demand from the artificial intelligence sector and constraints on production capacity. This will particularly increase production costs for electronics, cars and technology goods.

## GENERAL GOVERNMENT FINANCING

**The general government budget deficit is forecast to increase to 4.2% of GDP this year.** There are two main reasons for this. The first is that the change to the income tax system that began to apply at the start of the year and that eliminated the regressive principle behind tax-free income and increased the tax-free income rate will substantially restrict growth in revenues. The second is that the plans accounted for in the forecast will raise spending on national defence to 5% of GDP this year.

**The budget deficit will increase further in 2027.** The deficit next year is forecast at 4.9% of GDP and the increase will come because growth in revenues will slow further while spending on defence will continue to increase. The growth in tax revenues was still supported in first half of 2026 by the rise in VAT on 1 July 2025, but there are no major measures planned for increasing tax revenues in the coming years. Tax revenues will also be reduced in 2027 because some wage recipients have not used their tax-free income in 2026 and their excess income tax will need to be returned in 2027. Non-tax revenues will be limited in 2027 by a fall in the total value of foreign financing.

**The changes to the income tax system and the rise in spending on defence will increase the budget deficit permanently and no additional revenue or saving measures are planned to cover them, and so the budget deficit will remain wide moving forwards.** Current assumptions indicate that the budget deficit in 2028 will be the same as in 2026 at 4.2% of GDP.

**The increasing budget deficit will boost domestic demand in the short term, but will lead to faster growth in the debt level and in interest expenses, and will make the overall state finances significantly less sustainable.** The current forecast is that the general government debt will exceed 16 billion euros by the end of 2028, or a little over 33% of GDP, and that the interest payments to service it will be 455 million euros a year. That is 0.9% of GDP or almost 2.3% of the forecast general government revenues in 2028. Rising interest expenses will leave less fiscal headroom, as a larger part of revenues will be needed for servicing the existing debt, and will not be available for new spending or for financing tax cuts. Box 4 analyses the fiscal position that would be needed to keep the public debt stable.

## *Box 3: Alternative scenarios for the economic impact of the conflict in the Middle East*

The war in the Middle East affects the Estonian economy directly through higher commodities prices and indirectly through supply chains and elevated geopolitical uncertainty. Given the large amount of uncertainty around events in Iran and the Strait of Hormuz, three alternative scenarios have been produced alongside the baseline scenario. They are a mild scenario, an adverse scenario where the situation deteriorates, and a severe scenario where the disruption is even more intense.

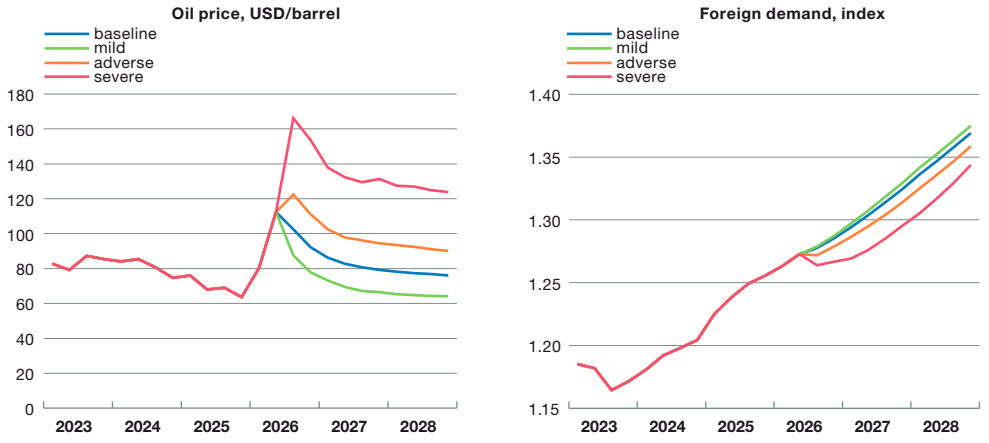
### Assumptions in the scenarios

The scenarios do not use specific assumptions for how long the conflict will last or about the damage caused during it, but commodities prices are calibrated using market-based probability distributions. The impact on the global economy, including on foreign demand for Estonian exports and prices in trading partners, comes from the estimates of the European Central Bank. It is also assumed that fiscal and monetary policy do not react to additional measures. The construction of the scenarios and the changes in the external environment under them have been defined by the European Central Bank (see Table B3.1).

**Table B3.1. Alternative scenarios and impact channels**

| | Mild | Adverse | Severe |
|---|---|---|---|
| Commodities prices – oil, gas, food commodities | Energy prices in the 25th percentile of the market-based probability distribution | Energy prices in the 75th percentile of the market-based probability distribution | Energy prices in the 95th percentile of the market-based probability distribution |
| Uncertainty | | Increased stock market volatility (VIX +10 p, falls by the end of 2026) raises the price of financing | Increased stock market volatility (VIX +14 p, falls by the end of the forecast horizon) raises the price of financing |
| Foreign demand and prices in trading partners | European Central Bank estimates of how commodities prices and uncertainty affect the euro area and the global economy in the three scenarios, given the direct and indirect effects on demand and prices. | | |
| Fiscal and monetary policy | It is assumed that fiscal and monetary policy do not react to changes in the economic environment. | | |

Figure B3.1. External assumptions for alternative scenarios




Sources: European Central Bank, Eesti Pank

The distribution of market expectations raises the oil price per barrel in the severe scenario to 166 US dollars in the third quarter, after which it remains around 50 dollars or 60% higher than in the baseline scenario until the end of the forecast horizon (see Figure B3.1). The impact on the price of natural gas is even larger. The adverse and mild scenarios differ much less from the baseline scenario.

Estonia has few direct trade connections to the conflict area, but high energy prices, increased uncertainty and more expensive food will reduce global economic activity, and so also demand for exports from Estonia. Higher commodities prices drive inflation up, reducing the real incomes of households and restricting spending on consumption and investment. The consequence is then a reduction in demand for exports from Estonia. The impact on foreign demand is amplified by increased global uncertainty that makes financing conditions tighter.

The global economy is hit in the adverse scenario by a small but lasting supply-side shock, and foreign demand for Estonian exports remains around 1% lower than in the baseline scenario until the end of the forecast horizon. The same channels operate in the severe scenario, but the impact is larger and foreign demand is almost 2% lower by the end of 2028 than in the baseline scenario (see Figure B3.2).

The scenarios do not assume that increased uncertainty affects consumption and investment decisions in Estonia directly[15]. Like in the approach of the European Central Bank, it is assumed that the volatility in stock markets caused by the uncertainty affects the price of financing for companies and households. The short-term rise in the VIX index in the adverse scenario implies a rise of 0.1 percentage point in interest margins. The effect on margins in the severe scenario is double that, as it is assumed that volatility increases by more and for longer.

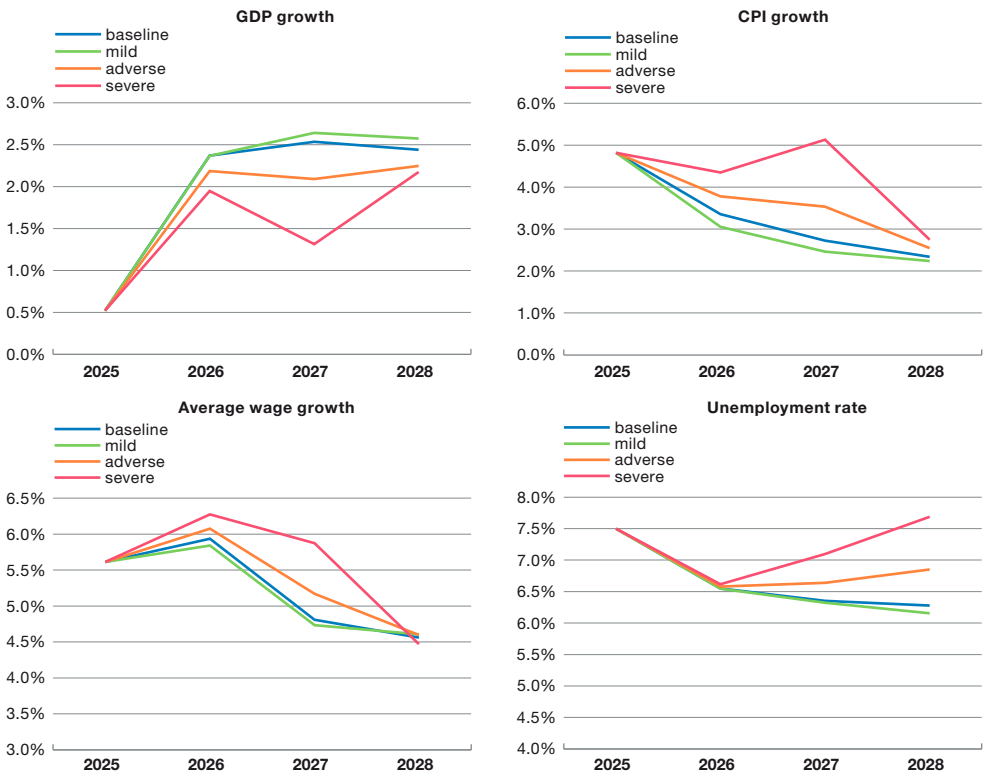
## Outcomes of the scenarios[16]

As expected, higher commodities prices on global markets mean higher inflation and lower economic growth for Estonia. The external assumptions in the adverse scenario and the mild scenario are relatively similar to those in the baseline scenario, and so the impact on inflation and growth in those cases is quite modest (see Figure B3.2).

15 The level of global uncertainty does however indirectly affect foreign demand for Estonian exports and price changes in trading partners.

16 The Eesti Pank macro model EMMA is used to estimate the impact on the Estonian economy.

Figure B3.2. Results for alternative scenarios




Sources: Statistics Estonia, Eesti Pank

The economic environment in the severe scenario would be much more difficult for Estonia. The direct impact of commodities prices and the higher price levels in Estonia's trading partners would mean that inflation in the severe scenario is 1 percentage point higher this year and 2.4 percentage points higher next year before it returns to close to the level in the baseline scenario. The biggest change is in the price of energy, both directly because of the oil price, which passes through into prices for liquid fuels, and because a higher gas price means larger bills for heating and electricity.

High inflation partly passes through into wage growth but still exceeds it, and so the growth in real wages for households and their ability to consume are less than in the baseline scenario. Slower growth in foreign demand hurts the outlook for exports and combines with higher financing costs to restrict growth in investment. Economic growth in the severe scenario slows to 1.3% next year, which is 1.2 percentage points lower than in the baseline scenario. It remains lower in the following year as well and chain-linked Estonian GDP is 2% smaller by the end of 2028 than in the baseline scenario.

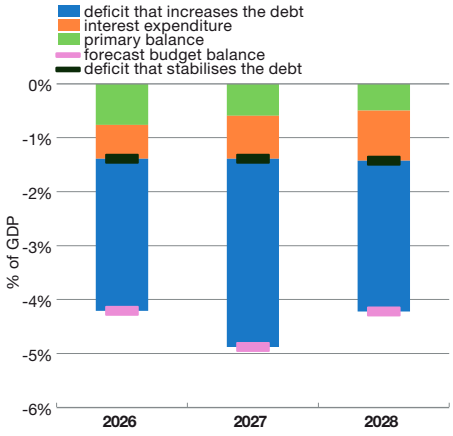
## *Box 4: The budget deficit that stops the debt ratio growing*

The debt of the Estonian general government has grown fast in recent years. The debt-to-GDP ratio in 2019 was 9%, but the Covid-19 pandemic and the recession and support measures that accompanied it caused the debt to increase to 19.1% of GDP in 2020. The debt has not stopped growing since then. The debt has been increased since 2022 partly by increased spending

on defence and partly by the weakness in the economic climate, and the general government debt reached 24.1% of GDP by the end of 2025.

Estonia's public debt is small in international comparison, but it is growing at a worryingly fast rate and the current budget plans do not show any indication of the growth stopping any time soon. The June forecast from Eesti Pank expects the budget deficit to widen sharply in 2026 and to reach 4.9% of GDP in 2027[17]. This would also mean that the general government debt-to-GDP ratio rapidly widens further in the coming years, and reaches 33% of GDP by the end of 2028. The most immediate negative impact of the growth in the debt would come from interest expenses rising. The larger the debt burden is, the larger the part of the budget that must be devoted to servicing it, and the less that remains available for other spending needs and for shaping tax policy.

Figure B4.1. Fiscal balance that stabilises general government debt




Source: Eesti Pank

In a simplified approach[18], the change in the ratio of debt-to-GDP in a given year depends on the general fiscal balance, nominal growth in the economy, and the existing debt ratio. A budget deficit where the debt to GDP ratio remains at the same level at the end of the year as it was in the previous year is defined by nominal GDP growth and the initial debt ratio[19]. The faster nominal GDP grows, the smaller the share of a given amount of debt in GDP becomes. This means that stabilising the debt ratio does not necessarily mean that the debt is not allowed to increase when expressed in euros, as it is enough for the debt to grow more slowly than GDP.

The Eesti Pank June forecast suggests that stabilising the debt ratio in the coming years would require a budget deficit of around 1.4% of GDP (see Figure B4.1). This indicator works on a yearly basis, so for 2027 it means the deficit that would keep the debt level the same at the end of that year as it was at the end of 2026. The stabilising deficit for 2028 equally shows the fiscal position where the debt ratio would not grow any larger than it was at the end of 2027. The deficit that is actually forecast exceeds this amount substantially in all of the years of the forecast horizon, and the gap between the stabilising deficit and the forecast deficit is in a range of 2.8-3.5% of GDP.

The budget deficit that stabilises the debt is sensitive to nominal growth in the economy. If nominal growth in the economy in the years ahead was one percentage point lower than forecast, the adjustment needed to stop the debt growing would be larger, and the deficit where the debt ratio would stabilise would shrink from 1.4% of GDP to 1.1%. With faster nominal growth, the growth in the debt would be stopped even with a slightly larger deficit.

The general budget deficit is of course only one part of the whole picture, as there are also the interest payments for servicing the existing debt, which increase as the debt grows and interest rates rise. This means that the general deficit that stabilises the debt does not show how much adjustment needs to be made in the rest of the budget. The higher the interest expenses are, the stricter the primary budget deficit before interest payments needs to be.

17 The forecast is based on plans that are known. The need to comply with the fiscal rules makes it probable that the budget for 2027 will aim to keep the deficit within the limit of 4.5% of GDP.

18 This excludes other possible factors that could change the debt without contributing directly to the deficit.

19 $bb_t^* \approx -d_{t-1} \times g_t \div (1 + g_t)$, where $g_t$ is nominal economic growth this year, $d_{t-1}$ is the debt to GDP ratio last year, and $bb_t^*$ is the fiscal position that stabilises the debt.

Interest payments in 2026-2028 are forecast to rise from around 0.6% of GDP to 0.9%. This means that even if the debt ratio were to stabilise at the level of the previous year with a general deficit of around 1.4%, there would still be less room within that deficit each year for other spending needs and for shaping tax policy. The primary deficit that is consistent with stabilising the debt ratio declines from around 0.8% of GDP in 2026 to 0.5% in 2028 (see Figure B4.1). However, the forecast for the primary deficit reaches 3.6% of GDP in 2026. If interest rates were to rise unexpectedly, interest expenses would increase even further. In that case the primary fiscal position required to stabilise the debt ratio would need to be even tighter, moving towards budget balance or even towards a surplus.

This means that the state finances face various challenges of different sizes in the coming years. After the exemption clause from the fiscal rules ends in 2029, the general government deficit will have to be brought back within the limit of 3% of GDP, but that would not be enough to stop the debt ratio from growing. The debt ratio can only be stabilised when the deficit is around 1.4% of GDP. Increasing interest expenses will at the same time gradually limit the options for the government in setting the rest of the budget. The longer the delay in stopping the debt ratio from growing, the larger the share of budget revenues that will go on interest payments, and the harder it will be to adjust the budget later.