Instytut Europy Środkowej

IEŚ Commentaries

No. 878 (126/2023) | 21.06.2023

ISSN 2657-6996

Bartosz Jóźwik

Estonia in the face of economic difficulties: an analysis of GDP decline and prospects for the future

Keywords: unemployment, public debt, Estonia, GDP, fiscal policy

The Estonian economy has been facing problems that have had a significant impact on its economic outlook. In 2022, Estonia's real GDP decreased by 1.3% compared to the previous year. Forecasts which indicate that the downward trend might continue in 2023 are also concerning. Interestingly, despite the unfavourable economic situation, there is a decrease in the unemployment rate in Estonia. The changing economic conditions, including inflation, pose new challenges for the government regarding long-term fiscal policy planning, including tax reforms.

Changes in real GDP. In May 2023, the European Commission published economic forecasts for EU member states titled "European Economic Forecast. Spring 2023", covering 2022-2024. Currently, the Estonian economy is facing many challenges that have impacted its economic performance. The country's real GDP decreased by 1.3% in 2022, which was primarily due to a significant decline in investments of foreign intangibles. This phenomenon indicates a significant change in the economy's structure, with a potential long-term impact on the country's competitiveness in the international market. Additionally, a negative trade balance has strongly impacted the economy. This is because Estonia's exports were unable to offset the rising costs of imports. The surge in import prices was particularly sharp, a direct consequence of Russia's war of aggression against Ukraine. Such external political factors can drastically affect the economies of small countries like Estonia, which are heavily reliant on international trade. The European Commission's spring 2023 forecast predicts a decrease in real GDP of 0.1% in 2023, followed by a 3.0% increase in 2024. The Commission identifies three main factors that will significantly influence Estonia's economic policy in the coming years.

Inflation. Firstly, high inflation. Rising prices make it difficult for consumers to maintain their standard of living, and for companies, it increases costs, which can lead to a downturn in investment and production. In the first quarter of 2023, HICP inflation remained high at 17.3%, but this is expected to gradually decrease. The energy component is no longer the main factor considering the fall in oil and natural gas prices and the implementation of economic policy instruments aimed at limiting retail electricity prices and curbing the growth of natural gas and heating prices („Komentarze IEŚ", nr 761). However, it should be noted that in the first quarter of 2023, the inflation rate for unprocessed food remained high at 26.5%, without signs of slowing down. Similarly, processed food prices were 20% higher than in the previous year. In contrast, prices for both non-energy industrial goods and services recorded an increase of about 12% in March, to which the intensifying wage pressure potentially contributed. The European Commission predicts that HICP inflation will start to decrease with the diminishing impact of energy and food price inflation. Forecasts also indicate that HICP inflation in 2023 will be 9.2%, then drop to 2.8% in 2024. This promises improved conditions for both consumers and businesses. Nevertheless, it will be necessary to monitor the situation and take appropriate economic actions at the government level to control inflation and minimize its negative effects on the economy.

Financing conditions and trade balance. Secondly, financing conditions are tightening. This raises significant concerns for companies that depend on the availability of loans to finance their operations and investments. There's a risk that rising credit costs and stricter lending conditions might suppress investments, which, in turn, would affect the pace of development of the entire economy. However, investments are expected to recover only slightly in 2023 amid tighter financial conditions before rebounding more strongly in 2024. A significant aspect is the fact that companies' balance sheets are generally good, which is optimistic news in the context of the potential tightening of financing conditions. Furthermore, a gradual reduction in the large accumulation of inventories in 2022 is also expected. Thus, even if the pace of investment recovery is slow, the good balance sheets of companies and the possibility of reducing inventory levels give reasons for optimism. Thirdly, the economies of Estonia's key trading partners (primarily Finland, Latvia, Sweden, and Lithuania) are experiencing slow economic growth. This limits the demand for exported goods and services, negatively impacting the country's trade balance.

Declining trend in the unemployment rate. Interestingly, despite the weak economic performance and low expectations, Estonia is experiencing a downward trend in the unemployment rate. It's worth noting that an unemployment rate of 5.1% in February 2023 indicates a relatively well-functioning labour market, which is quite unusual given the current economic challenges, including the influx of people fleeing the war in Ukraine („Komentarze IEŚ", nr 596). Incoming refugees increase the size of the workforce, which in turn can impact the structure of the labour market. In this context, the country's ability to integrate these new workers will be key to maintaining the declining trend in the unemployment rate. However, it is important to highlight the noticeable rise in wages, which is typically a direct consequence of labour shortages. Moreover, forecasts point to dynamic wage growth throughout 2023, primarily driven by the public sector. Despite this, predictions for 2023 suggest a weakening in employment growth, which is a consequence of limited economic activity. In this context, the unemployment rate is expected to increase to 6.2%. Even so, such forecasts are not alarming.

The government deficit. The changing economic conditions, including the decrease in real GDP and inflation, pose new challenges for the government in shaping fiscal policy in the longer term. The government deficit over the past few years shows large fluctuations, which are directly related to the country's financial policy. The significant reduction from 2.4% of GDP in 2021 to 0.9% in 2022 is a result of strong revenue growth, which was driven by inflation increasing VAT revenues and higher tax revenues due to employment growth. However, forecasts for 2023 indicate a significant increase in the deficit to 3.1% of GDP due to the planned significant increase in expenditure, especially in the public sector. It seems that the government is inclined to raise wages in the public sector and pensions, which – although it may bring positive social effects in the short term – could lead to fiscal problems in the long run.

Public Debt. The anticipated increase in public debt from 18.4% of GDP in 2022 to 21.3% in 2024 suggests that the government may require more resources to finance its expansive fiscal policy. The main planned tax changes concern the personal income tax system, an increase in VAT, adjustments and increases in corporate income tax, the introduction of a car tax, increases in environmental taxes, and excise duties on alcohol and tobacco. It is already known that according to the terms of the coalition agreement of the new government („Komentarze IEŚ", nr 801), VAT will increase by 2 percentage points from January 1, 2024, while from January 1, 2025, the personal income tax will rise by 2 percentage points for everyone. However, it is also worth noting that despite the increase in public debt, it will still be the lowest in the EU. According to statistics provided by Eurostat at the end of 2022, public debt ranged from 18.4% of GDP in Estonia to 171.3% in Greece, with an EU average of 84.0% of GDP.

Conclusions. Estonia's economy has faced many challenges, resulting in a decrease in real GDP by 1.3% in 2022. These can be divided into internal factors such as high inflation and tightening financing conditions, and external factors, primarily the impact of Russia's war of aggression against Ukraine and the economic slowdown among key trading partners. According to the forecasts of the Estonian government, there will be a further decrease in real GDP by 1.5% in 2023. However, in 2024, economic growth of 3.0% is expected. High inflation, especially noticeable in food and energy prices, is one of the main challenges the Estonian economy will face. Tightened financing conditions can deter businesses from investing, which in turn can affect the pace of development of the entire economy. Nevertheless, the good financial health of businesses gives cause for optimism. The Estonian government plans to implement a series of tax changes to finance its expansive fiscal policy. Despite this, the public debt is projected to increase from 18.4% of GDP in 2022 to 21.3% in 2024. However, it should be noted that Estonia's public debt will still be the lowest in the EU, which is a positive aspect of this economy. Despite economic challenges, the unemployment rate in Estonia is on a downward trend. However, the influx of refugees from Ukraine and the associated integration challenges may disrupt the current positive situation in the labour market.