ESTONIA

GDP growth is projected to gain momentum in 2017 and reach 2.9% in 2018, mainly driven by domestic demand. Private consumption will remain robust and public investment will pick up, sustained by EU funds. Despite a favourable business environment and good financing conditions, private investment will recover only slowly. Exports will strengthen backed by increasing external demand. However, maintaining price competitiveness will be challenging due to increasing labour costs.

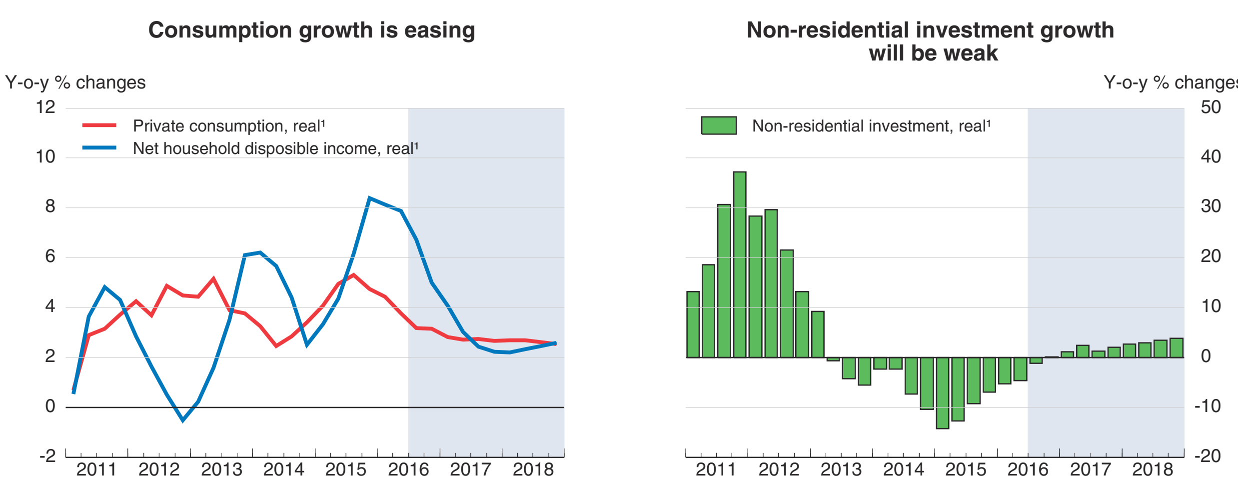
Fiscal policy will ease slightly but remain tighter than the fiscal rule of a structural balanced budget. Remaining inefficiencies in insolvency procedures, barriers to SME lending and labour shortages all undermine capital spending and productivity growth, calling for reforming the legal system, promoting new forms of business financing and strengthening the supply of marketable skills further.

With the lowest public debt in the OECD and a general government surplus in 2016, Estonia's fiscal position is very strong and prudent. The opportunity cost of this policy is high given the extremely favourable borrowing conditions and the need to fund growth-enhancing policies. Fiscal room should be used on measures to boost competitiveness and to make growth more inclusive, in particular by expanding active labour market policies and cutting labour taxes.

Domestic demand drives GDP growth

Output growth is driven by private consumption backed by rising household real disposable income. The labour market continues to tighten and wages are increasing fast. Inflation remains subdued due to earlier declines in commodity prices, despite rises in indirect taxes and unit labour costs. Exports are still held back by weak foreign demand and the high level of uncertainty about trade prospects. Business investment remains weak but may increase as confidence has strengthened and capacity utilisation has reached its long-term average. Tax receipts have been higher than expected and public investment

Estonia



1. Four-quarter moving average.
Source: OECD Economic Outlook 100 database.

StatLink http://dx.doi.org/10.1787/888933437576

Estonia: **Demand, output and prices**

	2013	2014	2015	2016	2017	2018
	Current prices EUR billion	Percentage changes, volume (2010 prices)				
GDP at market prices	18.9	2.7	1.5	1.1	2.4	2.9
Private consumption	9.7	3.4	4.8	3.2	2.7	2.5
Government consumption	3.6	2.5	3.4	0.1	1.5	1.3
Gross fixed capital formation	5.1	-6.9	-3.7	3.2	3.2	4.1
Final domestic demand	18.4	0.4	2.3	2.5	2.5	2.7
Stockbuilding[1]	0.1	2.4	-1.5	0.8	-0.2	0.0
Total domestic demand	18.5	3.0	0.7	3.4	2.3	2.7
Exports of goods and services	16.0	3.1	-0.6	3.9	3.8	4.3
Imports of goods and services	15.6	2.2	-1.4	6.6	3.5	4.1
Net exports[1]	0.4	0.8	0.6	-1.8	0.3	0.3
Memorandum items						
GDP deflator	_	1.9	1.0	1.7	2.4	2.6
Harmonised index of consumer prices	_	0.5	0.1	0.8	2.3	2.6
Private consumption deflator	_	0.5	0.0	0.7	2.3	2.6
Unemployment rate	_	7.4	6.2	6.9	7.6	8.0
General government financial balance[2]	_	0.7	0.1	0.4	-0.5	-0.1
General government gross debt[2]	_	14.1	12.9	12.4	13.1	13.3
General government debt, Maastricht definition[2]	_	10.7	10.1	9.5	10.2	10.4
Current account balance[2]	_	0.9	2.2	0.9	0.7	0.8

1. Contributions to changes in real GDP, actual amount in the first column.
2. As a percentage of GDP.
Source: OECD Economic Outlook 100 database.

StatLink http://dx.doi.org/10.1787/888933439037

lower than planned, suggesting the government will again outperform its fiscal targets in 2016.

Fiscal policy must support structural reforms

Fiscal policy will remain prudent: despite some easing in 2017, a surplus in structural terms will be maintained and the fiscal stance will be broadly neutral in 2018. A new tax refund for low-income earners, a higher family benefit and income tax allowance, and another significant increase in the minimum wage will support household purchasing power. Employer social security contributions will edge down from 33 per cent to 32.5 per cent and so only modestly mitigate the rise in labour costs.

Stronger fiscal easing would be appropriate given historically low borrowing costs, the very low level of debt (at around 10% of GDP) and the ample room for growth-enhancing policies. In particular, public spending can help to tackle upcoming supply-side constraints. Intensifying wage pressures and labour shortages will erode Estonia's competitiveness and its attractiveness for foreign investors. The tax wedge, which remains high by international standards, should be cut by further reducing social security contributions on low wage earners. The increase in the retirement age and the disability reform are expected to increase labour supply but active labour market policies should be stepped up to improve the employability of jobseekers. Also, more could be done to alleviate skill mismatch and boost labour productivity, notably by improving the quality of vocational education and removing infrastructure bottlenecks.

Investment will recover only slowly

GDP growth is projected to pick up gradually to 2.9% in 2018. Following a long slump, investment will resume, underpinned by recovering foreign markets, increasing profits and low borrowing costs. Growth will remain subdued, however, due to persistent uncertainty on trade prospects and geopolitical developments. Public investment will rise in 2017 as EU structural funds from the 2014-2020 allocation period are absorbed.

Growth prospects are sensitive to global demand, especially developments in Sweden, Finland and Russia. The export sectors could be hit by a lower-than-expected recovery in Russia and worsening geopolitical tensions. On the other hand, investment could be boosted by stronger demand from the euro area and the Nordic countries in particular. The consequences of Brexit on trade in the Baltic Sea region are surrounded with uncertainty. Risks to the outlook also come from the impact of recent reforms on labour shortages, productivity gains and competitiveness.