Estonia

Highlights

- **Growth has lost momentum while inflation has jumped sharply.** By mid-2022 the annual inflation rate exceeded 20 per cent, reaching the highest level since 1995, mostly driven by rising household expenditure on utilities.
- **The government introduced a number of measures in response to rising energy prices and inflation.** Assistance so far has included energy subsidies and partial compensation to eligible households for energy price increases, and a supplementary budget of €878 million has been set to cover unforeseen security-related expenses, support for Ukrainian refugees and further support to households to cope with surging energy prices.
- **The regulation of Virtual Asset Providers (VASPs) is being reinforced.** Important changes under a new draft law include tighter licensing rules, increased capital requirements and stricter information requirements in transaction originations.

Key priorities for 2023

- **Labour market reforms should be stepped up to help cope with immigration and demographic changes.** The large inflows of refugees fleeing the war on Ukraine and ongoing demographic challenges have highlighted the need to address labour shortages and skills mismatches by supporting active labour market policies, and bringing more refugees into the labour market.
- **Building on the timely implementation of the Recovery and Resilience Plan, Estonia will need to further progress its green transition.** The authorities should prioritise support for renewable energy production to achieve the target of 100 per cent of electricity consumption coming from renewables by 2030.
- **Further support to cope with the energy crisis should be targeted carefully.** While government spending should remain flexible to cope with extraordinary crisis expenses, support should be more targeted, focusing on the most vulnerable segments of society in order to avoid further inflationary pressures.

TABLE Main macroeconomic indicators %

	2018	2019	2020	2021	2022 proj.
GDP growth	3.8	3.7	-0.6	8.0	1.5
Inflation (average)	3.4	2.3	-0.6	4.5	21.0
Government balance/GDP	-0.6	0.1	-5.5	-2.4	-2.9
Current account balance/GDP	0.9	2.4	-1.0	-1.8	-0.2
Net FDI/GDP [neg. sign = inflows]	-4.8	-3.9	-10.4	-1.9	-2.9
External debt/GDP	77.9	76.1	88.8	84.7	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	62.3	60.2	63.8	59.8	n.a.

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Macroeconomic developments and policy response

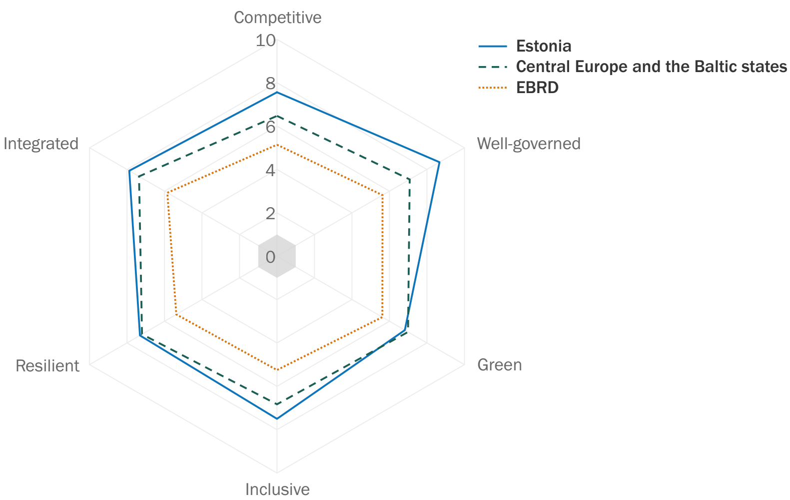
The economy has lost momentum in 2022. Following growth of 8.0 per cent in 2021, gross domestic product (GDP) growth slowed to 2.4 per cent year on year in the first half of 2022. Household consumption supported this growth, especially via higher spending on services that had suffered the most during the pandemic lockdowns. High levels of accumulated savings, money taken from the funded pension scheme as well as the government's energy price compensation measures were able to partially offset the negative impact on GDP of the historically high inflation (see below). Pre-sanctions trade with Russia was already low, so the slowdown in exports can be largely attributed to weaker demand from the European Union (EU). Despite the drop in growth, average employment grew to 81.9 per cent of the total labour force in the second quarter of 2022, while unemployment fell to 5.7 per cent in September 2022.

Inflation has jumped sharply. In September 2022 the annual inflation rate reached 24.1 per cent, down from 25.2 per cent in August 2022, and driven mostly by high household expenditure on energy, heating, gas and solid fuels, and food price growth. The average annual inflation is expected to exceed 20 per cent throughout 2022, and will likely not reach single digits until the second half of 2023.

The government has introduced measures to combat rising energy prices and inflation. In December 2021 energy subsidies worth €79 million, covered by revenues from the sale of CO_2 emission credits, were launched for households with incomes below €1,126 per month, and included full cover for gas network fees as well as compensation for 80 per cent of the increase in electricity costs, gas and district heating. In January 2022 the government discussed additional measures worth €90 million to target non-eligible recipients, and agreed to reduce network fees for businesses and introduce a cap on gas prices (€65 per MWh) and electricity prices (€0.12 per kWh). In May 2022 parliament approved a supplementary state budget of €878 million. It also passed amendments cutting excise duties on special purpose diesel, and lowered value added tax (VAT) rates applicable to press publications in an attempt to support free and independent quality media in Estonia. As a result of these measures, plus additional expenditure on defence and refugees, the general government deficit is expected to widen from 2.4 per cent of GDP in 2021 to almost 3.0 per cent in 2022.

GDP growth will slow further. The rapid rise in prices, especially energy prices, will weigh on household consumption and business performance in the short term. Weakening external demand in the EU will constrain Estonian exports, while expensive energy imports will weaken the terms of trade. Subdued corporate investments in 2022 are likely to rebound in 2023, when inflation eases and fresh EU funds will be more vigorously used by companies as the outlook improves. We therefore forecast GDP growth to remain subdued this year and the next, at 1.5 per cent and 1.0 per cent, respectively.

CHART Assessment of transition qualities (1-10)



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Structural reform developments

Efforts to strengthen energy security have been stepped up. In response to Russia's invasion of Ukraine, in May 2022 the supplementary budget included an additional €257 million for energy security-related measures. To become fully independent from Russian gas, the government is helping to develop the Paldiski Terminal so that it can receive liquefied natural gas (LNG), to be completed by the end of November 2022, and is supporting the leasing of a floating LNG terminal in partnership with Finland. A total of €242 million from the supplementary state budget was set aside to help Ukrainian refugees.

The government is supporting Ukrainian refugees' inclusion in the labour market. In the second quarter of 2022 there were about 3,300 Ukrainian refugees employed in Estonia, mostly in manufacturing, administrative and support services, trade, and accommodation and food services. At the same time, nearly 4,000 Ukrainian refugees were seeking employment through the Unemployment Insurance Fund. Additional funding will be provided to cover expenses for temporary protection of refugees, including healthcare, social benefits and employment support, as well as one-off grants for rental housing costs. Aid will also be given to the education system to accommodate Ukrainian children.

The government has adopted a new work plan for 2022-23. Approved in August 2022, it highlights eight areas of intervention, of which the three key priorities are: (i) enhancing the country's security, including cybersecurity of government digital services; (ii) in education, moving towards teaching purely in the Estonian language; and (iii) further supporting the population in coping with higher energy prices and inflation.

The government is reinforcing the regulation of VASPs. Estonia is a frontrunner among EU countries in cryptocurrency legislation. In December 2021 it introduced a draft law that will lead to tighter licensing rules – VASPs will need to meet additional requirements in order to obtain a licence, licensing fees will rise and capital requirements increased. In addition, the draft legislation introduced stricter transparency rules, ultimately aligning information requirements with those of banks and more traditional payment service providers. The purpose of the law is to regulate a significant portion of the fintech sector, thus reducing the risk of financial crime occurring and improving protection mechanisms. In June 2022 the Ministry of Finance announced the development of its first fintech strategy, aimed at supporting Estonian companies to exploit the full potential of fintech.

Implementation of the Recovery and Resilience Facility (RRF) is under way. Following the approval of Estonia's RRF in October 2021, the European Commission disbursed the first tranche of €126 million in pre-financing in December 2021. The funds are key in kick-starting the investments and reforms needed to meet a total of 71 milestones and 53 targets, mostly in green and digital transition, by 2026. Initial support for green transition included funding for energy efficiency projects for 2,600 housing units and the launch of a plan to strengthen the electricity grid and improve production capacity of renewable energy. Future green investments will mostly target businesses, supporting the development and use of new resource-efficient technologies and sustainable mobility, with sizeable investments in rail and tram infrastructure. Support for digital transition has already started with initial funding directed to digitalisation and automation of business processes, which will be followed by further enhancement of digital public services.