Estonia

Highlights

- **The economy continues to contract.** Net exports have slumped, reflecting persistent inflationary pressures and subdued demand in the region, but domestic inflation is now on a downward trend, with real wage growth turning positive again.
- **Estonia aims to enhance energy independence and renewable energy with European Union (EU) REPowerEU funds.** Ninety million euros in funds from REPowerEU, approved in December 2022, are expected to help the country counteract future energy shocks and accelerate the move to renewable energy.
- **Healthcare reforms are under way, targeting the accessibility and affordability of long-term care.** The country implemented the first reform in July 2023, which focused on reducing the costs of general care services and prepared the way for further reforms to enhance the quality and affordability of healthcare services.

Key priorities for 2024

- **Further efforts are needed to achieve energy independence from Russia.** This will require, among other things, Estonia to disengage from the Belarus, Russia, Estonia, Latvia and Lithuania (BRELL) power system by early 2025 and take steps to ensure the country has stable liquefied natural gas (LNG) sources if there are supply disruptions.
- **Green transition should be advanced towards the 2030 energy and climate targets.** The focus in the short term should be on attracting enhanced investments in renewable energy sources and retrofitting the housing stock for energy efficiency.
- **The Recovery and Resilience Plan (RRP) should be implemented in a timely way.** The country is set to receive a total of €3.5 billion from the 2021-27 EU budget for the green transition and socioeconomic development. However, further efforts are needed as the country has been slow to fulfil its RRP milestones and targets.

Main macroeconomic indicators (per cent)

	2019	2020	2021	2022	2023 proj.
GDP growth	4.0	-1.0	7.2	-0.5	-1.8
Inflation (average)	2.3	-0.6	4.5	19.4	10.0
Government balance/GDP	0.1	-5.4	-2.5	-1.0	-3.5
Current account balance/GDP	2.5	-1.9	-2.6	-3.2	1.9
Net FDI/GDP [neg. sign = inflows]	-3.8	-10.7	-2.4	-0.3	-0.4
External debt/GDP	75.6	88.7	85.1	84.7	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	59.8	63.8	60.3	58.3	n.a.

Macroeconomic developments and policy response

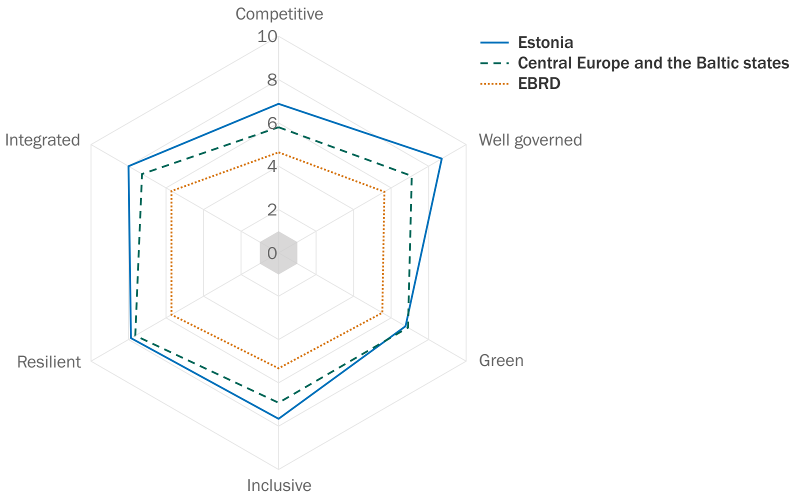
The economy remains in recession but is showing signs of a slow recovery. Gross domestic product (GDP) shrank by 3.3 per cent year on year in the first half of 2023 after contracting by 0.5 per cent in 2022, owing largely to the fallout from the war on Ukraine. Persistent inflation has taken a toll on real wages, and hence private consumption, while investment has continued to decline. Exports and imports are both falling due to weaknesses in the economies of key trading partners, resulting in worsening employment in sectors such as industry and trade.

Inflation is falling. The inflation rate peaked at 25.2 per cent in August 2022 but has been on a downward trend since then, reaching 6.4 per cent in July 2023, largely thanks to reductions in food, housing and transport prices. A further drop in inflation is likely as uncertainty concerning the war on Ukraine continues to translate into slower demand. Food and energy prices are easing, but retail sales (excluding vehicles) have fallen, reflecting the impact of past price increases on household consumption. The labour market remains tight, with an employment rate approaching historically high levels, but registered unemployment increased to 6.7 per cent in the second quarter of 2023. The country implemented several amendments to the Employment Contracts Act and Occupational Health and Safety Act, and the government raised the national monthly minimum wage from €654 to €725 in the winter of 2023.

Fiscal policy remains prudent. The government budget recorded a deficit of just 0.9 per cent of GDP in the first half of 2023. This result was better than expected and reflected higher tax revenues, partly owing to a strong rise in nominal wages. The deficit is forecast at 3.5 per cent of GDP for 2023 as a whole. To partially cover this deficit, in June 2023, the country increased the value of 10-year government bonds (worth €1 billion to date) by a further €500 million. General government debt in 2022 amounted to 18.4 per cent of GDP, still the lowest ratio in the EU.

An economic rebound is expected in 2024. Real GDP is forecast to shrink by 1.8 per cent in 2023, before recovering to 2 per cent growth in 2024. Private consumption is expected to pick up slowly in light of strong nominal wage growth in excess of inflation raising real disposable incomes. Exports are expected to remain subdued, given limited demand resulting from ongoing weaknesses in key trading partners. Key risks to the outlook are linked to the uncertainty caused by the war on Ukraine and concerns about energy security and energy price fluctuations.

Assessment of transition qualities (1-10)



Structural reform developments

Healthcare reforms have begun. The reforms adopted by the parliament in 2022 aim to improve the accessibility and affordability of long-term care and strengthen the quality of healthcare services. According to Eurostat data, self-reported, unmet healthcare needs amounted to 9.1 per cent in Estonia in 2022, versus an EU average of 2.2 per cent. The first reform, implemented in July 2023, aims to reduce out-of-pocket payments for general care services. The changes are part of Estonia's 16 key reforms under the RRP.

The pan-Baltic capital market is set to benefit from single index classification. The new single index, which was launched at the same time as the August 2023 Index Review, will allow the three markets to be integrated into the Morgan Stanley Capital International (MSCI) universe and will raise the region's profile among international investors who track MSCI indices. The approach is in line with efforts made by the ministries of finance in Estonia, Latvia and Lithuania, the European Bank for Reconstruction and Development, the European Commission and Nasdaq Baltic to create a single pan-Baltic capital market, as outlined by a memorandum of understanding signed in November 2017. The approach is also a building block of the EU's capital markets union initiative.

Efforts to become independent of Russian energy are intensifying. Estonia, along with Lithuania and Latvia, is continuing to move towards disengaging from the BRELL power system. In view of Russia's ongoing war on Ukraine, the three Baltic states have signed an agreement to accelerate this disengagement and focus instead on connecting to the European grid in early 2025. This means that the countries will officially inform all parties of their disconnection from the Russia-linked grid as early as August 2024. Estonia and Latvia signed a memorandum of understanding in May 2023 to jointly use the LNG terminal in the port of Paldiski in Estonia, via a floating storage re-gasification unit. The agreement aims to enable countries to purchase LNG if there are disruptions in natural gas supply.

The largest green energy tender has been held. This tender was launched in March 2023 and bids were submitted until September 2023. Power generation is expected to start no later than July 2027. The tender is expected to provide Estonia with 650 GWh of green energy, supplying around 215,000 households. This is the fifth national tender of this type in Estonia conducted by Elering, the national transmission system operator for electricity and natural gas. In February 2023 the country introduced subsidies for individuals and businesses to purchase zero-emission vehicles. The subsidies are worth €4,000 for individuals and €5,000 for companies per car, and €1,250 and €1,000, respectively, per bicycle.

There have been delays in the mobilisation of EU funds. The country is at risk of losing hundreds of millions of euros because of delays in meeting the necessary conditions. Of the €126 million of pre-financing the Ministry of Finance received in December 2021, €100 million remains unused. The EU recovery measures need to be aligned with a strict spending schedule, with operations of €1 billion to be completed by the first half of 2026. The country may otherwise lose funding intended to help mitigate the effects of the pandemic.

REPowerEU funds are targeting energy independence and renewable energy. The government approved €90 million of funding from the EU REPowerEU facility in December 2022 to counteract energy shocks and accelerate the development of renewable energy. The funding will help the country to achieve its target of full reliance on renewable energy sources by 2030, increase biogas production and deployment, strengthen grid integration capacity and allocate energy efficiency grants for small houses.

A major wind farm project is under way. The country's largest onshore wind farm, which should be completed in 2025, will increase national wind production by around 80 per cent. Enefit Green, an Estonian renewable energy company, secured €180 million to finance the project in September 2023. The wind farm is intended to cover 8.5 per cent of the country's electricity consumption and 40 per cent of households' energy needs.

A new car tax to reduce CO_2 emissions has been approved. The tax was adopted among several other amendments to tax legislation that parliament approved in July 2023. The tax includes a one-time registration fee and an annual fee based on CO_2 emissions and luxury car components.