Estonia

Highlights

- **Signs of a slow economic recovery are emerging after a deep recession.** Stronger external and domestic demand is helping the recovery, but ongoing issues such as increased taxes, declining productivity growth and a sharply appreciated real exchange rate remain significant obstacles to further growth.
- **The government plans to privatise seven state-owned companies to enhance transparency and economic efficiency.** Currently, 28 companies are state owned, and this decision is designed to stimulate the local capital market and allow non-strategic companies to be operated independently.
- **Estonia has introduced its first retail government bonds.** The bonds are targeting regular and professional investors with attractive returns. This initiative aims to diversify funding sources and strengthen the local capital market.

Key priorities for 2025

- **To enhance energy security, Estonia should accelerate the adoption of renewable energy sources.** Despite recent progress, oil shale remains significant in the energy mix, and issues such as insufficient grid capacity hamper further renewable deployment. In 2023, renewables accounted for 65 per cent of the energy mix, and the government is aiming for 100 per cent by 2030.
- **The government should leverage the planned increase in defence spending to develop state-of-the-art technologies in-house, benefiting multiple sectors.** This will drive productivity and innovation and strengthen international competitiveness in the face of rising labour costs.
- **A growth-oriented fiscal consolidation plan is needed to restore budgetary balance.** As the economy emerges from recession, this strategy could help gross domestic product (GDP) to recover by focusing on revenue generation and directing investment towards crucial areas such as digital and green transitions, a more robust and resilient labour market and targeted support for vulnerable households.

Main macroeconomic indicators (per cent)

	2020	2021	2022	2023	2024 proj.
GDP growth	-2.9	7.1	0.1	-3.0	-0.8
Inflation (average)	-0.6	4.5	19.4	9.1	3.6
Government balance/GDP	-5.4	-2.5	-1.0	-3.5	-3.4
Current account balance/GDP	-2.5	-3.6	-3.9	-1.7	-1.7
Net FDI/GDP [neg. sign = inflows]	-10.7	-3.1	-0.3	-7.7	-5.0
External debt/GDP	87.7	84.6	84.4	89.2	na
Gross reserves/GDP	na	na	na	na	na
Credit to private sector/GDP	62.9	59.8	57.6	58.5	na

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Macroeconomic developments and policy response

The economy has experienced the toughest broad-based recession since 2009. In 2023, real GDP contracted by 3.0 per cent, weighed by shrinking domestic demand, especially investments, as well as falling exports. The recession continued in the first half of 2024, with real GDP falling by 1.9 per cent year on year. Russia's war on Ukraine sparked supply-side disruptions, as raw materials such as oil, timber and minerals now need to be imported from more expensive markets. This loss of international competitiveness, further exacerbated by euro appreciation against the currencies of Estonia's key trading partners in the Nordic countries, contributed to a sharp drop in export volumes, by almost 10 per cent throughout 2023 and the first half of 2024. Since the Russian invasion of Ukraine, the European Central Bank's Harmonised Competitiveness Indicator shows a 12 per cent drop in Estonia's international competitiveness, down by nearly 19 per cent on pre-pandemic levels. Estonia's global export market share has fallen by 11 per cent over the past decade. Inflation has slowed, to 3.5 per cent in July 2024, but it remains at significantly higher levels than in Latvia and Lithuania. Services inflation, the second highest in the European Union (EU) at 7.6 per cent in July 2024, and the increased VAT rate introduced at the beginning of the year, are factors that hinder the decline in headline inflation. As a result, household consumption is reviving only slowly, further damped by historically low consumer confidence.

Rising production costs and weak external demand forced companies to cut back on both investments and hiring. In 2023, investment saw a drop of 3.0 per cent, while companies were operating at low capacity, triggered by elevated production costs, rising labour costs and weak demand. The unemployment rate increased from 5.1 per cent in the first quarter of 2023 to 7.8 per cent in the first quarter of 2024. The government introduced incentives to encourage further private sector investment in key areas such as renewable energy, information technology infrastructure and defence. However, competitiveness has suffered as cost pressures have mounted – concentrated on the labour supply side – and will require greater investment to boost productivity and value-added production capacity.

Estonia remains compliant with its deficit criteria. Despite a significant rise in the general government deficit from 0.9 per cent of GDP in 2022 to 3.4 per cent in 2023, Estonia was not included in the list of EU countries with imbalances, according to the European Commission's (EC) Spring 2024 European Semester package. Looking ahead, the deficit is projected to remain at 3.4 per cent of GDP in 2024, driven by ongoing defence investments and increased child benefits. In response, the government plans to introduce a series of tax hikes, including a two-percentage-point increase in the VAT rate and a rise in income taxes starting in mid-2025, and a temporary 2 per cent defence tax on corporate profits, which will fund essential military upgrades until the end of 2028. While this restrictive fiscal policy will likely hold back economic recovery to some extent, the new government is determined to keep the fiscal balance within the 3 per cent of GDP deficit threshold in 2025.

Positive growth is likely to return in 2025. Signs of recovery are apparent, driven by rising external demand from key international markets and increasing domestic demand. Factors such as improved business confidence, a broadly supportive policy environment and easing financial conditions are prompting companies to reassess their investment and hiring plans throughout 2024. However, underlying challenges persist, including structural issues such as declining productivity growth and the impact of a sharp real exchange rate appreciation. In addition, rising input costs, volatile commodity prices and supply chain disruptions continue to pose significant hurdles for the economy. In 2024, we anticipate a further contraction of real GDP, by 0.8 per cent, before the economy returns to growth, at 2.5 per cent, in 2025.

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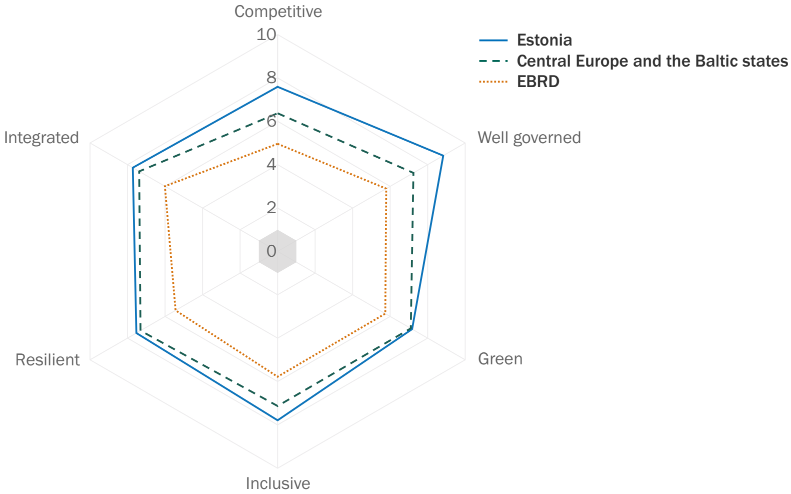
Assessment of transition qualities (1-10)



Structural reform developments

Seven state-owned companies are to be privatised. In February 2024, the finance ministry announced the full or partial privatisation of seven state-owned companies. Companies such as Teede Tehnokeskus (road maintenance), Operail (railway logistics), Nordic Aviation Group (airline) and Transpordi Varahaldus (transport asset management) will be divested, while the state will reduce its stake in AS Tallinna Sadam (port operator) to 51 per cent. Two subsidiaries of Eesti Energia – Enefit (energy solutions) and Enefit Green (renewable energy) – will be partially privatised. This move aims to raise transparency, improve finances and stimulate the local capital market. The government still holds stakes in 28 companies, with 23 fully state owned. The privatisation process is part of a broader strategy to allow independent operation of non-strategic companies and enhance economic efficiency.

The government has launched retail bonds for the first time. Estonia has introduced its first government bonds targeting retail investors, offering up to €200 million worth of two-year bonds with a 3.3 per cent annual interest rate from August 2024. The bonds, which can be purchased via banks, are expected to attract both regular customers and professional investors, offering a higher return than the 2.5 per cent interest that commercial banks offer on two-year deposits. This initiative follows the example of other European countries and is part of a broader strategy to diversify funding sources and boost the local capital market.

The European Commission is boosting funding for Rail Baltica. The European Commission has allocated an additional €1.2 billion to the Rail Baltica project, connecting Tallinn to the Polish border. Estonia will receive €370 million of this funding, contributing to a total budget of €1.5 billion, including national co-financing. The funds will support the construction of 55 km of the railway in Estonia, from Soodevahe to Alu. Rail Baltica aims to link the Baltic states with Poland by 2030, with an estimated cost of €15.3 billion. The economic benefits for the region are projected at €48 billion, surpassing the costs, according to the updated 2024 cost-benefit analysis. In 2024, around 15 per cent of the main line will be constructed, with passenger trains reaching speeds of 249 km per hour and freight trains 120 km per hour.

E-voting is becoming more accessible, helping to improve governance. In May 2024, Estonia's parliament passed a law to make e-voting more convenient and transparent by enabling voting via smart devices. This amendment, developed in response to recommendations from the Supreme Court, aims to ensure that e-voting is accessible to all citizens. The new rules, set to come into force in October 2024, are part of Estonia's broader strategy to enhance its digital democracy and maintain its position as a leader in e-governance. According to a recent survey[1] by the Organisation for Economic Co-operation and Development (OECD), Estonia ranks among the top countries globally in terms of e-government services.

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[1] OECD (2023), OECD Digital Government Index, OECD Public Governance Policy Papers, available at https://www.oecd-ilibrary.org/governance/2023-oecd-digital-government-index_1a89ed5e-en

Cross-border collaboration on hydrogen projects is advancing. In June 2024, nine transmission system operators around the Baltic Sea signed a memorandum of understanding to develop hydrogen infrastructure and common hydrogen markets. This initiative aims to shore up Estonia's energy security and reduce energy costs for companies. The common hydrogen market is projected to meet up to 45 per cent of the EU's planned hydrogen capacity by 2030. This move is part of Estonia's broader strategy to diversify its energy sources and reduce dependence on Russian oil and gas.

The Baltic states are exiting the Russian power grid. In July 2024 the electricity transmission system operators (TSOs) of Estonia, Latvia and Lithuania signed a declaration of non-renewal of the BRELL (Belarus, Russia, Estonia, Latvia and Lithuania) agreement, informing Russian and Belarusian operators of their withdrawal from the electricity ring. On 8 February 2025 the Baltic TSOs will disconnect the Estonian, Latvian and Lithuanian electricity systems from the Russia-controlled electricity system IPS/UPS and will start a joint isolated operation test. Afterwards, on 9 February 2025, they will synchronise with the electricity network of continental Europe. The EU has committed €1.2 billion to support this transition, covering about three-quarters of the costs.

Estonia's decoupling from the BRELL grid will raise electricity prices. With the shift from the Russian BRELL grid scheduled for February 2025, Elering, Estonia's electricity transmission operator, has proposed a new rate of €5.31 per MWh, up from €0.04. This increase accounts for the higher costs associated with managing grid frequency and securing reserves. This adjustment supports Estonia's goal of synchronising with the continental European grid and follows a broader investment plan of €700 million by 2028 for infrastructure, plus €160 million for renewable energy integration. This change is part of a regional effort with Latvia and Lithuania to enhance energy independence.

The Balticconnector pipeline has been repaired after damage. In April 2024, Estonia finished repairing the 77 km Balticconnector gas pipeline connecting Estonia and Finland. The €35 million project, initiated in March 2024, addressed damage caused by a vessel incident. The renewed gas flow enables Estonia to import gas from Finland's Inkoo terminal, crucial for the upcoming storage season. The closure of the pipeline in October 2023 due to a sudden pressure loss highlighted the need for robust infrastructure maintenance.