ESTONIA

Highlights

- **Estonia has been resilient to the deep recession in Russia.** Following modest growth in 2014, the economy continued to grow at 1.9 per cent in the first half of 2015. Companies successfully managed to diversify their exports away from Russia, while the ongoing decrease in oil prices further strengthened domestic demand.
- **The conclusion of the seven-year programme of European Union (EU) Structural Funds has boosted productivity and employment.** New operational programmes will support investments in the EU's 11 thematic objectives, including innovation in the private sector, a sustainable and cleaner transport, the quality of the education system and employment.
- **The government launched an e-residency programme in May 2015.** This enables foreign citizens to register businesses remotely in the country. Estonia is one of the most advanced countries in terms of the digitalisation of its administration services globally.

Key priorities for 2016

- **Estonia should establish market-based financial instruments for the utilisation of EU Structural Funds.** These instruments will be endowed with EU funds but will leverage private investment to extend repayable instruments to final beneficiaries, including in the form of equity and loan guarantees. The public-private funding mechanisms established in the form of the EU financial instruments could be especially relevant in fostering private investment, especially once the traditional grant funding has elapsed.
- **Cross-border connections for gas should be further diversified.** The pipeline between Estonia and Finland that is currently being planned and the associated liquefied natural gas (LNG) terminals in the two countries could further improve security of supply and facilitate competition in the wholesale market.
- **The high energy intensity of the economy should be addressed, in particular in the transport sector.** Energy efficiency in industrial and residential buildings should be improved, as well as in the transport sector, where clean technologies are poorly developed when compared with other EU countries.

Main macroeconomic indicators %

	2011	2012	2013	2014	2015 proj.
GDP growth	7.6	5.2	1.6	2.9	2.0
Inflation (average)	5.1	4.2	3.2	0.5	0.1
Government balance/GDP	1.2	-0.3	-0.1	0.7	-0.4
Current account balance/GDP	1.4	-2.5	-0.1	1.1	2.3
Net FDI/GDP [neg. sign = inflows]	-10.8	-2.3	-0.5	-2.8	0.3
External debt/GDP	93.3	102.3	95.6	94.6	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	78.1	72.6	69.2	68.1	n.a.

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Macroeconomic performance

Estonia managed to sustain modest growth in the face of a deteriorating external environment. After weak growth in 2013 of only 1.6 per cent, GDP grew by 2.9 per cent in 2014. This was supported by robust private consumption as wages grew strongly, pensions were raised, and inflation remained low. Domestic trade services and manufacturing were key sectors contributing to growth, whereas value added in the construction and transport sectors substantially decreased, in part due to the Russian embargo on food products from the EU. Investment activity has fallen continuously over six quarters. This reflects the rapid running down of the EU structural funds. New disbursements of EU funds for the 2014-2020 programming period are reviving public investment gradually over the course of 2015. Private investment growth has also been weak, as geopolitical tensions dampened domestic investment sentiment.

As a highly open economy, Estonia is profoundly affected by the slow-down in world trade volumes. In 2014, exports of goods and services rose only modestly, as the key export markets of Finland and Russia contracted (between them accounting for more than a quarter of exports). Exports to Russia dropped by 15 per cent last year. There have been concerns over the rapid increase in wage costs and a slight erosion in competitiveness, which is evident in the more rapid increase in unit labour costs over the past five years. As yet, Estonia's position in export markets does not seem to be under threat, as market shares have further expanded.

Low inflation rates in line with deflationary pressures in the eurozone. Following a 3.2 per cent increase in average consumer prices in 2013, inflation fell to only 0.5 per cent last year and turned negative to -0.3 per cent in September 2015. Price deflation could be a risk for Estonia, given the relatively high levels of corporate and household debt. However, alongside other euro area countries Estonia stands to benefit from the euro depreciation, and related quantitative easing by the European Central Bank (ECB).

Estonia continues to show the healthiest public finances in the EU. After registering small deficits in 2012 and 2013, last year the government registered a surplus of 0.6 per cent of GDP. This was due to higher tax revenues, a postponement of public investments and lower-than-anticipated social transfers. Recent income tax cuts and higher family benefits are expected to lead to a minor deficit of 0.2 per cent in 2015, according to the European Commission's (EC's) spring forecast. Public debt remains the lowest in the EU, at only 10.6 per cent of GDP in 2014.

GDP growth should strengthen over the medium term. The projected GDP growth is 2.0 per cent for this year, as the relatively strong industrial production continues to offset somewhat the weakened economic sentiment. Next year, GDP growth is likely to reach 2.8 per cent, underpinned by recovering investments and some improvements in external demand.

Major structural reform developments

Substantial progress in energy security has been achieved. Following the successful launch of the EstLink 2 power cable connection with Finland in March 2014, construction of the third electricity interconnection and related internal lines has been scheduled and is about to begin. The three Baltic states signed a roadmap agreement in December 2014, with a goal to synchronise their power grid systems with those of the other EU member states, in an effort to reduce dependence on Russia as a single source. The project is expected to be co-financed by EU funds, as part of the Baltic Energy Market Interconnection Plan and to be completed by 2025.

Gas supply sources have been diversified. The newly opened liquefied natural gas (LNG) terminal in Lithuania will for the first time diversify gas supply sources to the Baltic region. In addition, an agreement has been signed by Estonia and Finland in November 2014 to construct two additional LNG terminals. A larger terminal will be built in Finland, while a smaller distribution facility will be located in Estonia. Both terminals will be connected by the Baltic Connector pipeline and utilise Latvia's underground gas facilities. Estonia's government has pushed forward new investments to diversify gas supply sources, even though it started buying LNG from Lithuania in December 2014.

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Energy intensity remains very high. Estonia reached its EU target of 25 per cent use of renewable energy in gross final energy consumption in 2011. Despite substantial energy efficiency investments and measures to reduce energy consumption in housing and central heating systems, Estonia's energy intensity remains the second highest in the EU after Bulgaria. In February 2014, the parliament adopted the Transport Development Plan for 2014-2020, which outlines structural measures and incentives to create a more sustainable transport sector.

New EU Structural Funds aim to increase productivity and employment. During the 2007-2013 EU budgetary period Estonia was eligible for up to €3.4 billion in EU structural funds. Estonia's absorption rate has been the highest in the EU, standing at 94.9 per cent at the end of March 2015. During the budgetary period that has just begun (2014-2020), €4.4 billion will be available, of which €3.53 billion derives from the Cohesion Policy funds. The operational programme was approved by the EC in December 2014 and is designed to invest in 11 thematic objectives. In particular, it is dedicated to enhance research and development (R&D) and innovation in the private sector, create sustainable and cleaner transport, improve the quality of the education system and boost employment. As all other EU countries, Estonia will step up the use of financial instruments, as opposed to grants, in utilising EU funds.

The significance of technology-intensive exports continues to rise. In 2014, the share of smart manufacturing exports reached 16.3 per cent of total exports, a figure for the first time above the EU-wide average. R&D expenditures had been rising rapidly until 2011, although a sizeable drop to 1.74 per cent of GDP was registered in 2013, primarily due to termination of a large investment in the oil industry. The newly established financial instruments, that will be endowed with 2014-2020 EU funds but will also attract private funding, will improve funding for innovative enterprises and thus facilitate new investments in high-value added sectors.

Estonia became the first country to offer e-residency digital citizenship. In May 2015 the government launched an e-residency programme that enables foreign citizens to register businesses remotely in the country. As Estonia is the most advanced country in terms of the digitalisation of its administration services globally, the e-resident solutions allow managing a company, declaring taxes and performing banking transactions from the other side of the world.

Some progress in labour market policies has been made. The labour force has been shrinking since 2006, and is expected to contract by a further 26 per cent by 2050, according to the EC's *Ageing Report 2015*. Emigration and declining population figures have tangibly impacted the labour market, including in terms of skills shortages. The Lifelong Learning Strategy 2014-2020, approved by the parliament in February 2014, followed by an Adult Education Act and a Professionals Act, both adopted in early 2015, are expected to improve the match between lifelong learning opportunities with the needs of the labour market.