Estonia

Country note, January 2018

Key messages:

- **Economic growth exceeds 4% in 2017 and is expected to remain strong in the years ahead**
- **Government budget is in a small nominal and structural deficit in 2018**
- **New fiscal rule allows for structural deficits, but the target may not be met in 2018**

Macroeconomic outlook

Economic growth picked up in 2017 and averaged almost 5% over the year during the first three quarters, and it is projected to surpass 4% for 2017 overall. This has largely been driven by surging public and private investment and a favourable external environment, while wages continue to grow relatively rapidly, supporting domestic demand. Growth is expected to remain robust in 2018, with the Ministry of Finance forecasting real GDP growth of 3.3% (see Chart 1).

The Ministry's macroeconomic forecast was endorsed by the Fiscal Council, which considered risks to the growth outlook for 2018 to be balanced. Looking forward, economic growth is expected to converge to its long-term sustainable rate of close to 3% after 2018.

Fiscal outlook

In 2017, the general government is expected to record a balanced budget in both nominal and structural terms. Government balances are set to deteriorate in 2018, with the nominal deficit projected by the Ministry at −0.1% of GDP and the structural deficit at −0.25%, despite rapid revenue growth. However, the risks to the fiscal outlook are greater than usual because of the numerous large-scale tax changes in the form of personal and corporate income tax reforms, and excise hikes, which increase the chances of forecast errors.

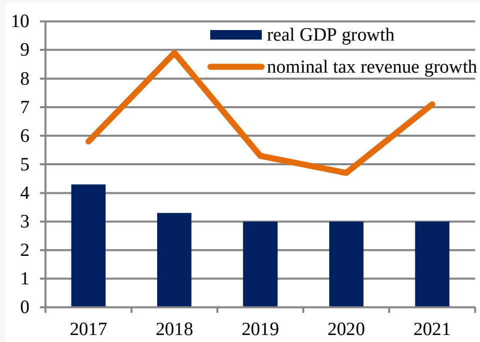
The Fiscal Council has stressed the uncertainty related to tax revenue yields and the absence of economic slack (see Chart 2), and has recommended that the government plan for a small budget surplus. In the medium term, budget deficits in 2018−2019 mean that the net financial position of the state is expected to weaken slightly.

Fiscal framework and national fiscal rules

Several changes to the national fiscal framework were introduced by the new government in 2017, most notably the replacement of the requirement for annual structural balance with a more complex budgetary rule that allows for a structural deficit of up to 0.5% of GDP. Also, the MTO was lowered to −0.5% of GDP. At the time, the Council voiced its concerns about the manner and the timing of the change in the rule, which allowed looser fiscal policy in a cyclical upswing.

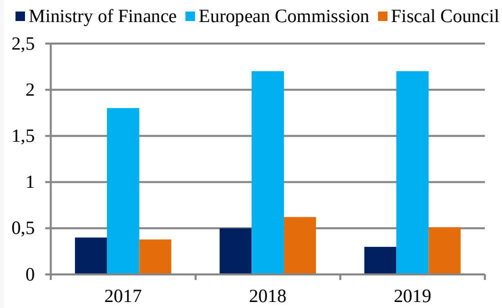
While the Ministry forecasts a structural deficit in line with the fiscal rules at 0.25% of GDP in 2018 and 2019, calculations by the Fiscal Council using the disaggregated framework show structural deficits of close to 0.5% of GDP (see Chart 3). In the opinion of the European Commission, the deficits will be even larger and indicate a possible breach of the fiscal rule.

Chart 1: Growth in the economy and tax revenues (% y-o-y)



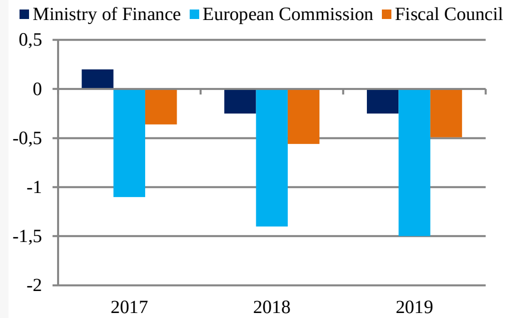
Source: Ministry of Finance

Chart 2: Estimates of the output gap (% of pot. GDP)



Source: Ministry of Finance, European Commission, Fiscal Council

Chart 3: Estimates of the structural balance (% of GDP)



Source: Ministry of Finance, European Commission, Fiscal Council

Key indicator forecast

		2016	2017 f	2018 f	2019 f	2020 f	2021 f
Real GDP growth	[% y-o-y]	2.1	4.3	3.3	3.0	3.0	3.0
Output gap	[% of pot. GDP]	−0.6	0.4	0.5	0.3	0.1	0.0
GG nominal balance	[% of GDP]	−0.3	0.0	−0.1	−0.3	0.2	0.6
GG structural balance	[% of GDP]	0.2	0.2	−0.25	−0.25	0.0	0.5
GG debt	[% of GDP]	9.4	9.0	8.6	8.4	7.7	7.0

Source: Ministry of Finance

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