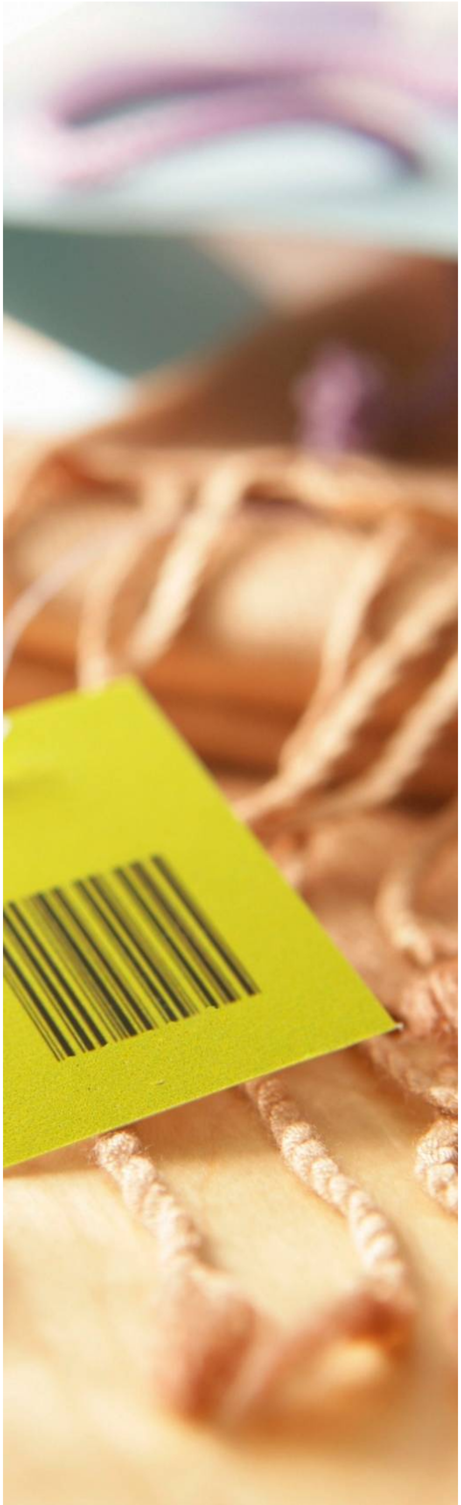
Newsletter



The Estonian Economy

GDP data magic

- GDP growth has been faster than what was reported before
- But growth is still unbalanced …
- … and downside risks prevail

GDP growth has been faster than what was reported before

Economic growth in Estonia looks much stronger in the first half of this year after the substantial data revisions by the Statistical Office this September. There was no decline in economic activity in the first quarter as was reported earlier. According to the revised data, GDP growth accelerated from 0.3% in the first quarter to 2.4% in the second quarter. Higher GDP growth is more in line with other economic indicators, i.e., the fast growth in wages, retail sales, and real estate prices.

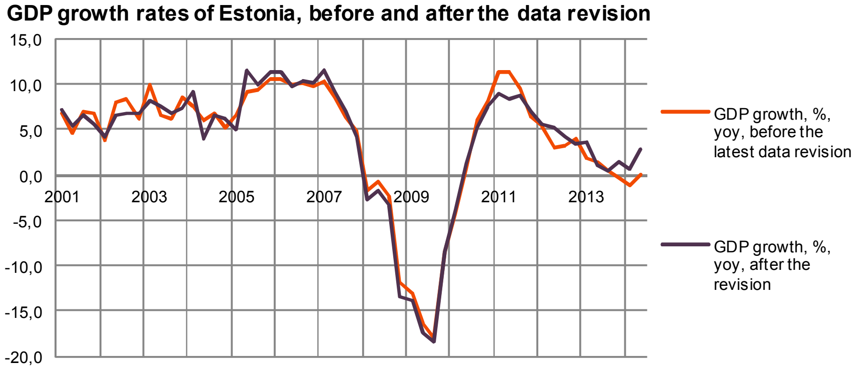
But growth is still unbalanced and therefore unsustainable ...

In the second quarter of this year, economic growth was still too dependent on private consumption. Investments grew modestly. The growth of exports remained small, affected by weak external demand and increased geopolitical tensions. In a tiny, open economy like Estonia, consumption-based growth cannot continue for long, if exports and investments do not pick up.

… and downside risks prevail

As the economic growth rate of Estonia for the first half of the year was lifted considerably, analysts might consider revising their forecasts upwards later this year. At the same time, negative external risks have clearly grown. The Russia-Ukraine conflict and new round(s) of sanctions from both sides have increased the instability in the region and will dampen trade and investment flows.

GDP growth rates of Estonia, before and after the data revision



Source: Statistics Estonia, Eurostat

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GDP data magic

GDP growth in Estonia looks much stronger in 2013 and in first half of 2014 after the data revision published this September. But economic growth is still unbalanced and, therefore, unsustainable, depending too much on consumption and retail trade. Exports, hampered by weak external demand and increased geopolitical tensions, remain relatively weak. Russia and potential new round(s) of sanctions are the biggest risk to the economy at the moment.

GDP data have been revised

GDP growth rates revised up for 2013 and first half of 2014

On September 8, 2014, Statistics Estonia published revised GDP time series from 2000 until the second quarter of 2014. Due to changes in GDP data, the growth rate of the economy in the first half of this year looks much stronger than before; also there was no decline in economic activity in the first quarter as had been reported earlier. According to the revised data, GDP annual growth accelerated from 0.3% in the first quarter to 2.4% in the second quarter. Higher GDP growth is more in line with other economic indicators, i.e., the fast growth in wages, retail sales, and real estate prices.

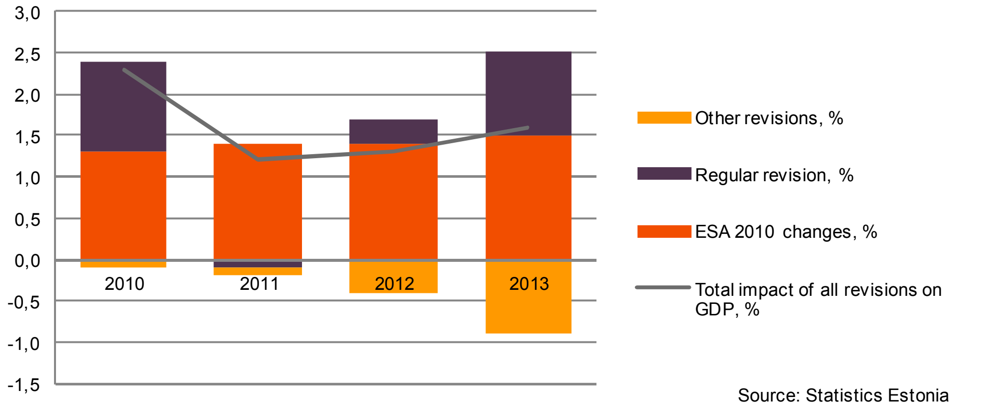
A total of 44 revisions were made to GDP data this month. The main purpose of the revision was to update the internationally used GDP methodology from the European System of National and Regional Accounts of 1995 (also called ESA 1995) to that of 2010. But other revisions were carried out as well – new data sets were introduced and, in some cases, calculation methods were improved.

Some of the most important changes were as follows:

- More detailed datasets were used that had become available, e.g., the supply-and-use tables of 2010 and the Structural Business Survey of 2012.
- The main methodological rulebook for calculating GDP was changed from ESA 1995 to ESA 2010. The new methodology treats research and development (R&D) and military expenditures as investment. Research that mostly universities and enterprises undertake is now considered part of their investment activity in GDP, even when they are not able to sell the results of their research on the market directly. The inclusion of R&D expenditure changed GDP levels the most, not only in Estonia but also in other countries that have already revised their GDP data.
- The results of the 2011 Population and Housing Census were taken into account.

After the revisions, the annual GDP at current prices changed, on average, by 1% in 2000–2013 (between –0.2% and 2.3% per year). During the same period, the real growth of annual GDP changed by –1.1 to 0.1 percentage points.

Impact of data revisions on Estonia's nominal GDP



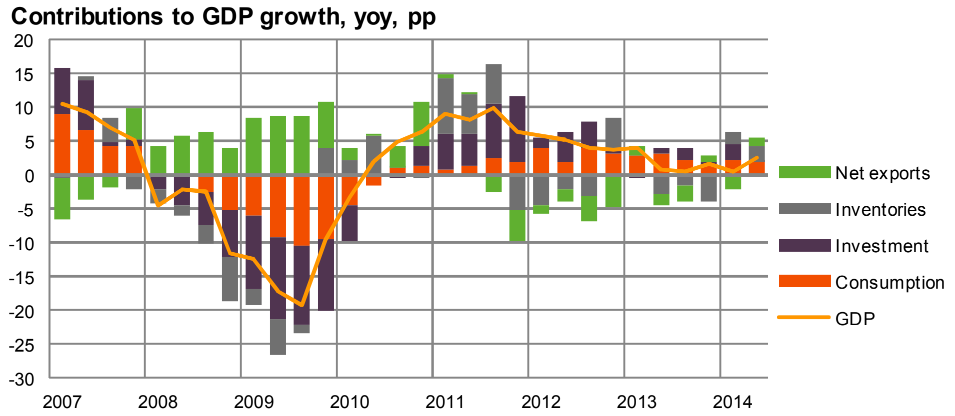
Source: Statistics Estonia

Most of the European countries will publish their revised GDP data series by the end of September. The average impact of the data revision in the EU is expected to be in a range of +2…+3% of GDP. Lithuania will publish its revisions on Oct 3 and Latvia later this month.

The overall growth story has not changed, however

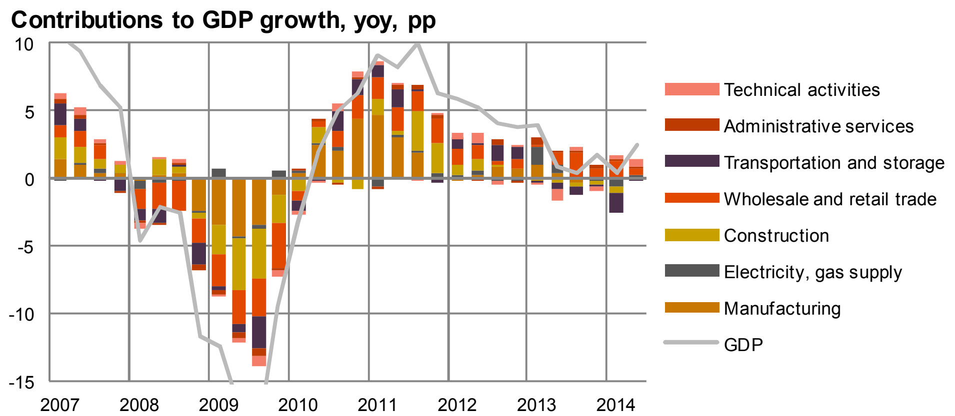
Consumption remains the main driver

In the second quarter of this year, economic growth was still driven by domestic demand, namely, higher inventories and private consumption. Investments grew modestly, supported by investments of enterprises. Public investment volumes declined due to smaller EU-related funding. Growth of exports remained low as the volume of exports of goods decreased. The volume of both exports and imports of goods declined compared with the second quarter of last year due to smaller volumes of production, subcontracting works, and transit trade. Goods imports were also influenced by low investment activity. The exports of services, especially transport services, seemed to be unaffected by weak external demand and remained strong, as in the first quarter of this year.



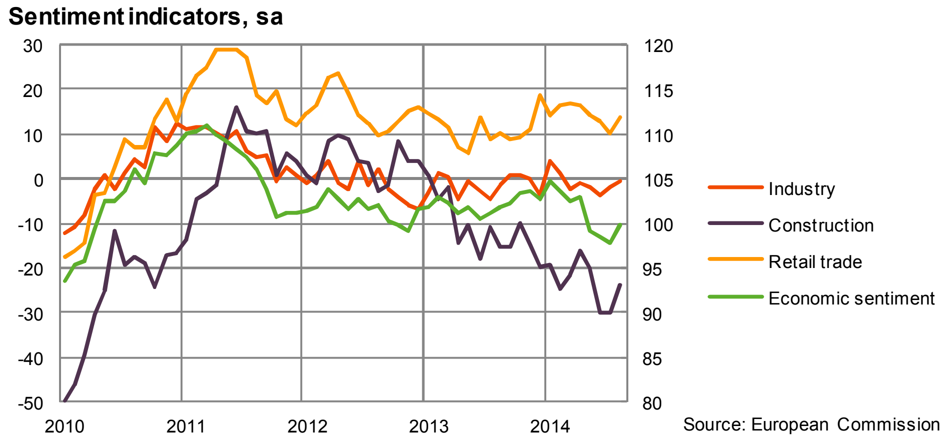
Source: Statistics Estonia

The economic growth picture by economic sectors showed the same story. Although the growth rate of GDP accelerated in the second quarter, the economic situation remains fragile and the only firm supporter of the economy is consumption and domestic trade. Exports and the value added of the manufacturing sector remain relatively weak. GDP growth is unbalanced and unsustainable in the current manner. Value added in the transport sector declined due to smaller volumes of land transport, although the situation in water and air transport was better (causing a surge in the exports of transport services).



Source: Statistics Estonia

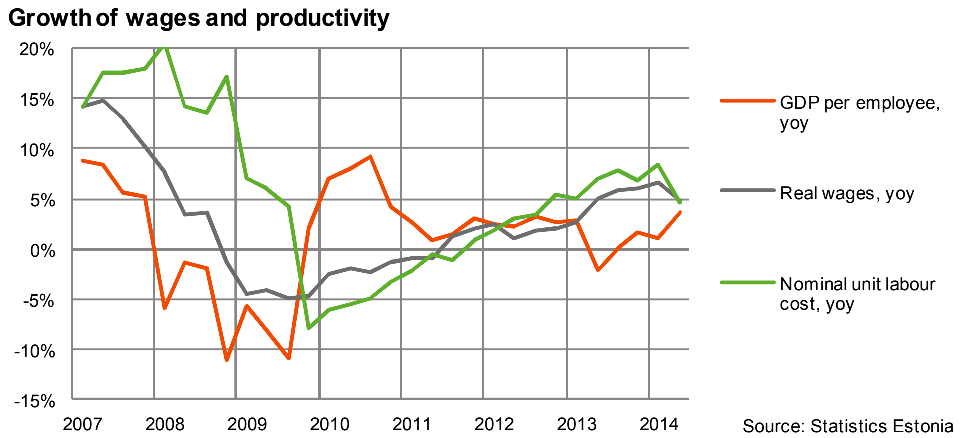
The diverging situation in different economic sectors in Estonia is well seen in the economic sentiment survey results, in which Estonia's retail traders seem to be unaffected by the relatively gloomy picture in other areas, especially construction; this sector is waiting for the new EU funding period's infrastructure projects to start at the end of the year.



Economic growth forecasts that have been published during the past two weeks (but before the GDP data revision) have forecast economic growth of between 0.5% and 0.8% for Estonia for this year. As the economic growth rate of Estonia in the first half of the year has been raised substantially, analysts might consider revising their forecasts upwards later this year.

Risks are clearly on the downside

Domestic risks surrounding economic development of Estonia remain significant but have decreased a little compared with the first quarter. Although economic growth is still too dependent on consumption and the too-fast growth of wages (compared with productivity gains), tensions on the labour market eased a little in the second quarter. The growth of wages and unit labour costs (i.e., the average cost of labour per unit of output) has finally started to decelerate. Also, productivity data look better after the GDP data revision. The growth of real estate prices, albeit still one of the highest in the EU, also decelerated a bit in the second quarter with the rising supply of new apartments in Tallinn.



At the same time, external risks have clearly grown. The Russia-Ukraine conflict and new round(s) of sanctions from both sides have increased the instability in the region and will dampen trade and investment flows. According to the most recent data, after the first six months of 2014, Estonia's exports of goods and services to Russia were down by 28% (goods -41%, and services +5%, compared with the same period last year). A large part of this decline is, however, transit goods, which have limited impact on the value added in Estonia.

Liis Elmik

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