FISCAL COUNCIL OPINION ON THE SUMMER FORECAST 2022 OF THE MINISTRY OF FINANCE

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Contents

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Opinion

The summer economic forecast 2022 the Ministry of Finance is supposed to give a basis for preparing the state budget 2023 and the state budget strategy 2023–2026 that is up-to-date and is as accurate as possible. It is the task of the Fiscal Council to assess whether the forecast by the Ministry of Finance is suitable for this.

There are two parts to the economic forecast by the Ministry of Finance, with a macroeconomic forecast and the outlook for public finances. Under the State Budget Act, the macroeconomic forecast should describe the national economic environment and probable developments in it, and inform the public of this. The fiscal forecast should be written using the most likely scenario in the macroeconomic forecast, or a more conservative one.

The Fiscal Council does not endorse the summer economic forecast 2022 of the Ministry of Finance as it does not use the most likely expectations about general government spending, which affects the forecasts for both future growth in the economy, and internal and external balance.

First, the summer forecast includes assumptions of general government consumption and wage growth that are based on the previous state budget strategy produced a year and a half ago. These forecast assumptions are now out of date because of high inflation. The budget strategy and its spending forecasts are usually updated every 12 months, but in this case a change to the law meant that there was a longer gap between the two strategies. Second, the summer forecast did not take account of the spending planned by the new government coalition that was announced in July. The summer forecast of the Ministry of Finance consequently underestimates substantially the amount of general government spending, the budget deficits and the debt levels for 2023–2026, and this then affects the other economic indicators that are forecast.

Inflation has increased in Estonia over the past year and has consistently exceeded the expectations of forecasters. Higher inflation than expected raises both the revenues and the expenditures of the general government above the initial plans. The excess revenues from consumption and labour taxes increase the revenues in the state budget immediately, but the impact of inflation on the expenditures side is only felt in full after some delay. Higher tax revenues will leave the fiscal position better than expected this year, but the increase in expenditures caused by inflation should be reflected in the fiscal position in the coming years. The summer forecast by the Ministry of Finance unfortunately does not describe this.

The government has already started discussing the state budget 2023 and the new budget strategy. The Fiscal Council considers it important that the state budget strategy 2023–2026 that will be composed by the end of September contain an updated macroeconomic forecast by the Ministry of Finance for 2022-2026 that uses the most recent information on the budget measures planned by the new government coalition, and an updated estimate of the development of general government wage costs, consumption and investment. This would give the Riigikogu and the public a more up-to-date and accurate view of the fiscal policy planned by the government and its forecast impact on the Estonian economy.

The Fiscal Council recommends that the future forecasts of the Ministry of Finance should contain two scenarios, one based only on budgetary measures that are already legislated, and a second that the ministry estimates to be the most probable scenario for the state finances.

Chairman of the Fiscal Council
Raul Eamets
Tallinn, 6 September 2022

Explanatory Report

Russia's military invasion of Ukraine has made the economic environment very uncertain and forecasting extraordinarily difficult. For this reason the Fiscal Council is focusing in its comments about the economic forecast of the Ministry of Finance on the years 2022–2023. Like in the spring, the Fiscal Council sees that the biggest threat to growth in the Estonian economy comes from the uncertainty surrounding prices of commodities on global markets, from supply-side constraints and weak economic sentiment, and from broadly based inflation.

Assessment of the macroeconomic forecast

Since the start of the Covid-19 pandemic, it has mainly been the case when forecasts were updated that although the future seemed even less clear than had earlier been thought, the economy had performed better than feared. Since the spring forecast of the Ministry of Finance was written, the high prices of commodities and supply problems have caused high and broadly based inflation that has then in combination with increased uncertainty and tighter financing conditions started to cool global demand.

The expectations of growth in the spring forecast were based on the information available to the Ministry of Finance in the middle of March and were more cautious than those in other forecasts. The Fiscal Council considered at the time that it was justifiably conservative. Given this, it was to be expected that the short- term figures for real growth would be corrected upwards. The higher yearly average figures for growth this year reflect what has happened in the first half of the year (see Table 1).

Table 1. Key economic indicators in the summer forecast for 2022–2023 (%)

	2022		2023	
	Summer 2022	Spring 2022	Summer 2022	Spring 2022
GDP at current prices (billion euros)	36.5	32.7	38.6	33.9
Real GDP growth	1.0	−1.0	0.5	1.2
Real growth in private consumption	0.4	−4.6	1.4	0.1
Real growth in end consumption by the government	−1.5	−1.4	−1.2	0.0
Real investment growth	−12.5	−7.2	3.7	3.9
Real growth in exports of goods and services	3.0	−2.0	1.6	2.3
Real growth in imports of goods and services	−0.6	−6.6	0.3	2.1
Change in CPI	19.5	12.7	6.7	2.1
Nominal growth in the average wage	11.0	7.0	7.4	5.6
Growth in employment	2.9	−0.1	0.5	−1.2

Source: Ministry of Finance

Growth in domestic demand was largely driven from January to June by private consumption, which was some 7% more than in the same months a year earlier. Spending by households has partly been financed by the money withdrawn from the second pension pillar. This suggests that the forecast made in spring 2022 for private consumption of –4.6% was too pessimistic and so it is reasonable for that figure to be changed.

On the other hand, the forecast for growth for this year may overestimate the contribution of general government investment to growth in the economy, as it assumes for example that it could be 1.8 times more in the second half of this year than it was in January to June. High inflation may lead to some investment being postponed or even abandoned completely.

Inflation has been notably higher than was expected in spring, and it is increasingly hard to distinguish between the changes in economic output that come from higher prices and those that come from larger volumes[1]. According to the summer forecast, inflation will accelerate for longer than was thought in the spring. Forward transactions in the middle of August indicate that the fall in prices of important fuels like gas and oil that was expected for early 2023 will now happen in the summer. It is consequently natural that the largest changes from earlier forecasts mainly concern price indexes (see Figure 1 left panel).

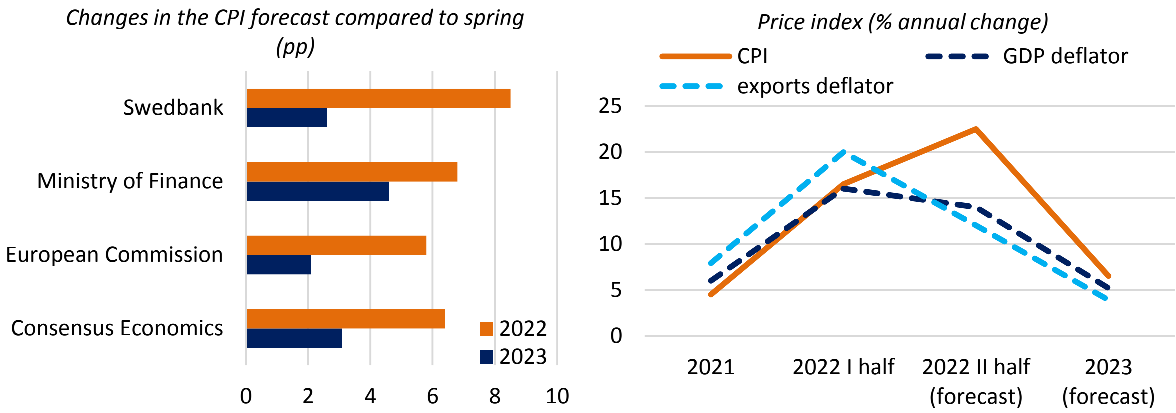

Figure 1. Changes in the CPI forecast and the price indexes in the summer forecast of the Ministry of Finance 2022–2023

Sources: Ministry of Finance, European Commission, Swedbank, Consensus Economics

The Ministry of Finance forecast higher consumer price inflation for 2022 at an average for the year of 19.5% than any of the other forecasts released in July and August. Technical analysis shows that even at this level the rise in the price of the consumer basket from the previous month should not on average be more than 0.5% in August to December. This implies a very sharp change from the figure for the past three months of over 2%, meaning that consumer price inflation may prove higher in the coming half year than forecast (see Figure 1 right panel). This risk also affects other price indexes or deflators, and may indicate unexpected changes in relative prices.

The first half of the year does not unfortunately give any indication of how labour market participants will act during a time of very high inflation (see Background 1). Labour costs grew by noticeably less than corporate profits in the first quarter of the year. At the same time, wage growth was very different across sectors, ranging from 2% to 40% in the second quarter. Annual growth of labour costs reached 18% in April to June, meaning they increased at the same rate as GDP. The forecast of the Ministry of Finance assumes that the average wage level in 2023 will be 17% higher than it was in 2019. Such a jump in wages could in future threaten the competitiveness of exporting companies.

Two notable features can be identified for the current forecast update that will make it notably harder to make macroeconomic forecasts for the coming year and a half. The first is that the figure for inflation is more important than usual because of the higher price level. This comes with the worry that the quality of price statistics will deteriorate at a time of high inflation. The second is that the summer forecast of the Ministry of Finance has underestimated the amount of general government spending and so its impact on the macroeconomic indicators.

[1] Yearly growth at current prices in imports and exports between Estonia and some key trading partners was 25-30% in the first half of 2022, while estimates for price indexes were between 20% and 25%.

Assessment of the fiscal forecast

Budgetary position in 2022

For the third year in a row the Ministry of Finance is forecasting in the autumn that the nominal fiscal deficit of the general government will be notably smaller than was forecast in the spring (see Figure 2). In the past two years the actual fiscal position at the end of the year has proved even better than was expected in the forecasts written during the year.

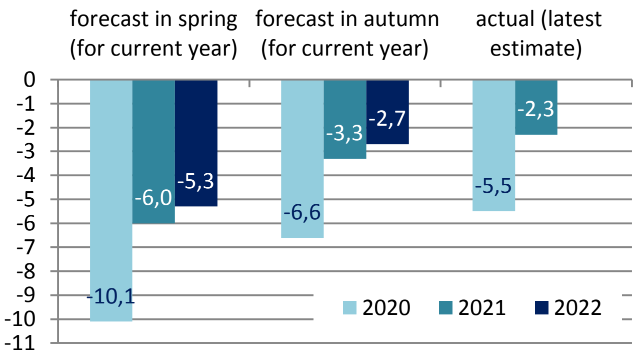

Figure 2. Forecasts for the general government nominal balance in 2020–2022 (% of GDP)

Sources: Ministry of Finance, Statistics Estonia

The economy and state finances were affected most in 2020 and 2021 by the unforeseen Covid-19 pandemic and the measures taken by the state to stop the spread of it and ease the economic impact, but 2022 has been dominated by the unexpected Russian invasion of Ukraine and the high inflation sparked by the sharp rise in energy prices. The current estimate by the Ministry of Finance of Estonia's economic circumstances is consequently also significantly different from what was forecast in summer 2021 when the state budget 2022 was written, or in spring 2021 when the current state budget strategy for 2022–2025 was produced (see Table 2). Although real growth in the economy has been slowed by the uncertainty caused by the war and by high inflation, key macroeconomic indicators that affect state finances and especially tax receipts, such as nominal GDP, are better than was earlier forecast.

Table 2. Forecasts of the key macroeconomic indicators for 2022 by the Ministry of Finance

	Spring 2021	*Summer 2021*	*Spring 2022*	*Summer 2022*
CPI (%)	2.1	3.7	12.7	19.5
GDP deflator (%)	2.1	3.3	7.8	14.8
Real growth in GDP (%)	4.8	4.0	−1.0	1.0
Nominal growth in GDP (%)	7.0	7.4	6.7	16.0
Output gap (% of GDP)	−1.0	0.6	−2.0	−0.6
GDP at current prices (billion euros)	30.5	32.4	32.7	36.5

Source: Ministry of Finance

The changes in the economic climate and the appearance of new shocks have led to frequent changes in the targets for the budgetary position of 2022 (see Figure 3). The summer economic forecast 2022 of the Ministry of Finance expects the general government nominal deficit next year to be 979 million euros or 2.7% of GDP. In spring the ministry was estimating that the deficit for the whole year would be 1.72 billion euros, or 5.3% of the GDP forecast in spring. According to the summer forecast, the Estonian general government nominal deficit will not exceed the Maastricht criteria of 3% of GDP for a second consecutive year.

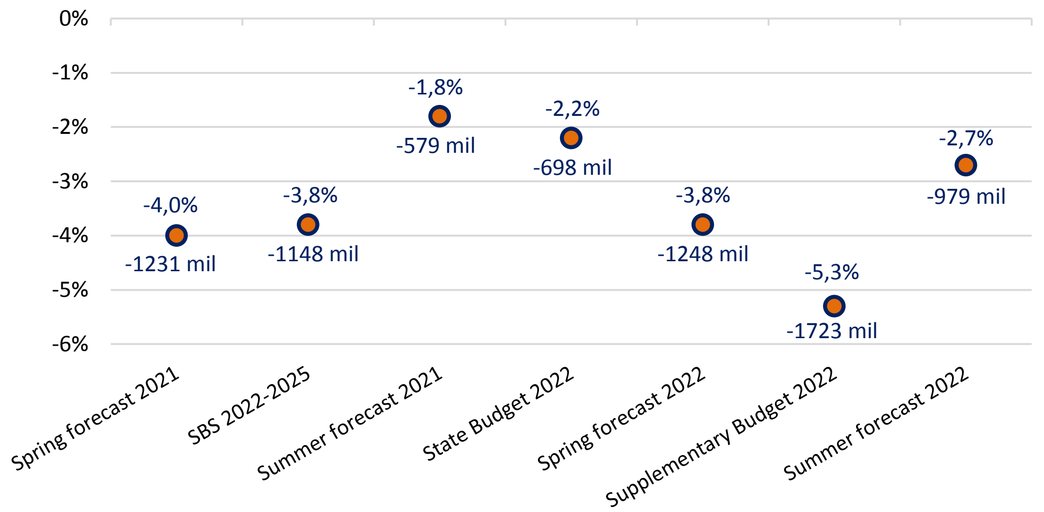

Figure 3. Forecasts for the general government nominal balance in 2022 (% of GDP)

Source: Ministry of Finance

The Ministry of Finance estimates that the general government nominal deficit in the first six months of the year was only 115 million euros, or 0.3% of the expected GDP of 2022. The forecast of the ministry consequently suggests that the budget deficit must deteriorate sharply in the second half of the year and spending must exceed revenues by more than 860 million euros.

The deterioration in the forecast budget position should come primarily from the expenditures side, as the Ministry of Finance assumes on the revenue side that the flow of excess taxes will even increase in the second half of the year from what was earlier forecast. Tax revenues in the first six months of 2022 were 156 million euros more than was forecast in the supplementary budget passed in the spring, and in the second half of the year the extra tax revenues are being put at almost 600 million euros. Better than expected tax receipts can be explained by the strong position of the labour market and higher inflation. The spring forecast of the Ministry of Finance expected inflation to peak in the first half of this year, but the summer forecast expects this will happen in the second half and at a much higher level.

It is quite typical for general government expenditures to be largest in the final quarter of the year, but on top of this the dynamics of expenditures in 2022 will also be affected by the supplementary budget from the spring, which was put together after Russia's unexpected invasion of Ukraine. The supplementary budget for 2022 was passed by the Riigikogu at the end of May, and so most of the expenditures in it will fall in the second half of this year. The supplementary budget increased spending on refugees from the war, defence and energy security, and its impact on the budget for 2022 was estimated in spring at around 630 million euros. This makes it reasonable that the general government fiscal position will deteriorate by more in the second half of 2022 than usual.

In total the Ministry of Finance is forecasting large excess tax revenues in the second half of the year, but a sharp deterioration in the general government fiscal position. The nominal budget deficit of the general government in the first half of the year was 0.3% of GDP, but the summer forecast expects this to rise to 2.7% of GDP by the end of the year, or 979 million euros. The deterioration in the fiscal position in the second half of the year is mainly explained by the expenditure measures in the supplementary budget 2022. The forecast for the fiscal position is still notably better than it was in the spring, when the deficit was expected to reach 1.72 billion euros. The forecast is mainly better because of higher revenues from tax receipts, CO2 quotas and environmental fees, while the forecast for general government expenditures in 2022 has also come down a little.

Forecast of the budgetary position for 2023–2026

Inflation has increased in Estonia over the past year and has consistently exceeded the expectations of forecasters. Higher inflation than expected raises both the revenues and the expenditures of the general government above the initial plans. The excess revenues from consumption and labour taxes increase the revenues in the state budget immediately, but the impact of inflation on the expenditures side is only felt in full after some delay. Higher tax revenues will leave the fiscal position better than expected in 2022, but the increase in expenditures caused by inflation should be reflected in the fiscal position in the years ahead. The summer forecast by the Ministry of Finance unfortunately does not describe this.

The summer forecast of the Ministry of Finance has updated the forecast for general government revenues and expenditures in 2023-2026 (see Figure 4). Higher inflation than expected in 2022 will affect the whole of the forecast horizon, as future growth in prices and in the economy will start from a much higher level than was earlier expected, leading also to larger tax receipts. The forecasts for general government revenues have been increased by around 0.8-1.3 billion euros depending on the year, while significant changes in the general government expenditures are only evident from 2025. The Fiscal Council considers that the Ministry of Finance has not used the most probable assumptions for general government expenditure in compiling the summer forecast.

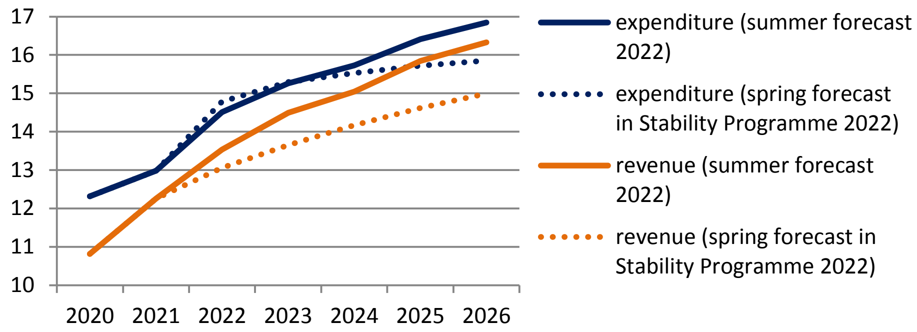

Figure 4. Forecast for general government revenues and expenditures (billion euros)

Source: Ministry of Finance

The summer forecast includes assumptions of general government consumption and wage growth that are based on the previous state budget strategy produced a year and a half ago. These forecast assumptions are now out of date because of high inflation. For example, the summer forecast of the Ministry of Finance expects general government expenditures to grow by 5.2% in 2023 and then afterwards by around 3-4% a year, and that wage growth in the public sector will on average be only 4% in 2022–2026. The budget strategy is usually updated each year, but this time a change in the State Budget Act meant that there was exceptionally one and a half years between the two strategies released in spring 2021 and summer 2022.

Further to this, the writing of the summer forecast did not take account of the new spending planned by the government coalition that was announced in July[2]. The impact on the budget of the measures planned by the new coalition will be felt from 2023 and most of the measures involve additional expenditure in every year across the forecast horizon. The fiscal impact of the new expenditure measures is not yet known in sufficient detail, and so Figure 5 shows only indicative trajectories for the budget deficit if the

[2] The new government coalition has promised to raise the benefits for first and second children and for single parents, to raise and index benefits for large families, to raise the minimum tax-free threshold, to transition to education in Estonian, to increase funding for higher education, to postpone rises in excise, and to provide support measures for energy prices.

budgetary impact each year of the additional expenditure measures should be 300, 400 or 500 million euros.

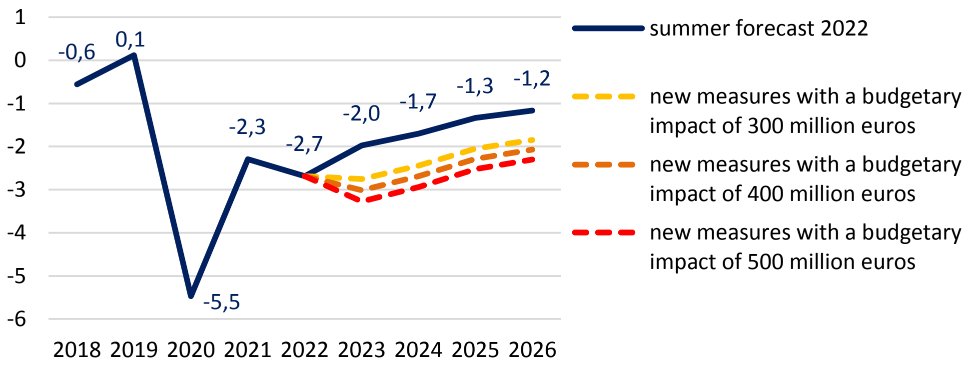

Figure 5. Forecast for the general government nominal balance in 2022–2026 (% of GDP)

Sources: Ministry of Finance, calculations of the Fiscal Council

The summer forecast of the Ministry of Finance expects the nominal budget deficit of the general government will start to narrow year by year from 2023, to reach 1.2% of GDP by 2026, but as already explained, this is based on a forecast for expenditures that will be changed substantially during discussions this autumn about the state budget and the budget strategy. As general government expenditure already exceeds revenue in the current unrealistically low spending forecast, and the policy measures announced by the new government coalition will increase spending further, it may be assumed that the budget deficit will be deeper and the general government debt burden larger than is projected in the fiscal forecast issued by the Ministry of Finance in summer 2022.

In summary the Fiscal Council finds that the summer forecast of the Ministry of Finance underestimates substantially the amount of general government spending, the budget deficits and the debt levels for 2023–2026, and this then affects the other economic indicators that are forecast. The Ministry of Finance has followed its usual practice in compiling the forecast by basing it on the most recent state budget strategy and only using budget measures that have actually been passed, but the missing amount of spending and its potential impact on the macroeconomic indicators in the forecast is in this case larger than usual. For this reason the Fiscal Council does not endorse the summer economic forecast 2022 of the Ministry of Finance.

Following its usual schedule, the Ministry of Finance will next release a macroeconomic forecast only in spring 2023. The Fiscal Council considers it important that an updated macroeconomic forecast by the Ministry of Finance for 2022–2026 be included in the state budget strategy that will be written by the end of September, using the most recent information on the budget measures planned by the new government coalition, and an updated estimate of the development of general government wage costs, consumption and investment. This would give the Riigikogu and the public a more up-to-date and accurate view of the fiscal policy planned by the government and its forecast impact on the Estonian macroeconomy.

The government has already started discussing the state budget 2023 and the new budget strategy, basing this discussion on the summer economic forecast of the Ministry of Finance. The Fiscal Council recommends that the future forecasts of the Ministry of Finance should contain two scenarios, one based only on budgetary measures that are already legislated, and a second that the ministry estimates to be the most probable scenario for the state finances.

With regards to the support measures for energy prices, the Fiscal Council recommends following the advice of international organisations (see Background 2), which favour measures that are targeted as accurately as possible and focus on the households and sectors affected most by inflation.

Compliance with the fiscal rules

In addition to assessing the official macroeconomic and fiscal forecasts, it is also the task of the Fiscal Council to monitor compliance with national fiscal rules, the most important of which is the structural budget balance rule. When the escape clause of the European Union's fiscal rules was activated at the start of the pandemic in early 2020, the national budget balance rules were also automatically suspended.

The European Commission announced in May 2022 that the escape clause will continue to apply in 2023 because of the increased uncertainty caused by the war in Ukraine and the rapid rise in energy prices. This means there will be a period of at least four years during which breaches of the fiscal rules will not lead to any sanctions. The Fiscal Council has not been able during this time to release its usual opinions and recommendations on the government fiscal position under the requirements of the fiscal rules.

Despite tax receipts being better than expected in 2022, the nominal fiscal position of the general government remains deeply in deficit, by almost 1 billion euros by the end of the year according to the summer forecast of the Ministry of Finance. The budget deficit in 2020 was 1.5 billion euros, and in 2021 it was 0.7 billion euros. The Fiscal Council considers that assessment of the plans of the new government coalition to reduce the structural budget deficit should be based on the state budget strategy 2023–2026 being prepared for the end of September, as the summer forecast 2022 of the Ministry of Finance does not give a full view of the fiscal measures planned by the government for the coming years.

Background 1. *The main risks in the short term*

As a very small and open economy, Estonia is heavily dependent on what happens abroad. The external assumptions in the macroeconomic forecast of the Ministry of Finance are usually imported, but when the summer economic forecast was written it was not yet possible to get reliable forecasts from Estonia's main trading partners about their future demand for imports. The assumption about demand for goods and services exported by Estonia is consequently similar to that in the forecast made in the spring, which expected real growth in the short term of 2-3%. It was not yet known when the forecast was written whether those assumptions would need to be changed or not.

Forecasting import prices, which have a major effect on producer prices and export prices, was also much more difficult than earlier. Forecasting prices became harder with the start of the coronavirus pandemic, which led to blockages in production and in the operation of supply chains. The war between Ukraine and Russia and the sanctions applied gradually to Russia and Russian countermeasures are further affecting the global economy, primarily the balance of demand and supply for energy and fuels and commodities.

Prices for imports and exports of goods and services were on average 28-29% higher in the first half of 2022 than they were a year earlier. Information on fluctuations and even falls in the prices of some commodities such as oil and wood had been received when the forecast was written, but there was no sign yet of any clear downwards trend in inflation. High inflation was also a major factor in the rising value of foreign trade. There is a danger when inflation is high that the quality of price statistics may fall, as the structure of goods and services that are exported may change rapidly, and may no longer match the basket used for calculating export prices.

Overall the risks to the accuracy of external assumptions have increased substantially. It could already be noticed in 2020–2021 that the forecast errors for indicators for the external economic environment were larger than those for the domestic economy (see Table 3).

The largest risks with domestic assumptions are this time also connected to prices. Some estimates show that around half of the contents of the consumer basket is of foreign origin. The GDP price index or deflator is, however, supposed to measure domestic price pressures, primarily those from the rise in the price margins of businesses and from labour costs. It is to be expected that with high inflation and global supply shocks the gap between these two indicators would widen. The forecast made in 2022 shows a gap of five percentage points for the year on average between the CPI and GDP deflators. This is not unheard of in the past, but it is deserving of an explanation in the explanatory note of the summer forecast.

There is also more uncertainty than before in forecasting the key indicators for the labour market. Around 50,000 refugees from the war in Ukraine have arrived in Estonia so far. The Ministry of Finance has taken a more optimistic view of their integration into the labour market than earlier, and assumes that refugees starting work will increase the number of people in employment by 0.7-0.8% in 2022–2023. It is hard to estimate the attitudes of the refugees and whether their willingness to work will meet the expectations of employers[3].

It is also unclear whether the broader use of foreign labour will start to affect average labour costs. It is quite unusual that the rise of 9.7% in the average wage in the first half of 2022 was smaller than the rise of 16.5% in consumer prices, and real wages are expected to fall further in the second half of the year, with falls of 5.8% in the first half of the year and 8.4% in the second.

[3] When the forecast was written, refugees from Ukraine made up 11% of the officially registered unemployed, and more than 7000 of them had found a job.

Table 3. Accuracy of some of the main forecast assumptions in 2016–2021

	Difference from the forecast, mean absolute deviation (pp)		
External assumptions	*2016–2019*	*2020–2021*	*Notes*
Real growth in foreign demand, mostly found from import demand in 40 partner countries (%)	0.9	7.1	Difficult to find forecasts made at current prices
Price index for imports of goods and services, deflator (%)	1.2	5.2	Energy prices rose faster than expected at the end of 2021
Price index for exports of goods and services, deflator (%)	1.3	5.7	Risk that the change in export prices is slower than the rise in input prices
Real growth in exports of goods and services (%)	0.6	8.2	Tying growth in exports to foreign demand has so far worked well methodologically
Domestic assumptions			
CPI (%)	0.9	2.5	Assumptions drawn from future transactions by market participants were not very accurate in 2021
GDP price index (deflator, %)	0.9	3.1	The difference from CPI was still within one percentage point in 2016–2019
Change in employment (%)	0.8	2.2	The tendency over the past decade has been to underestimate growth
Average change in real wages (%)	1.5	1.8	Real wages increased by 2.3-6.2% in 2016–2019

Sources: Ministry of Finance, calculations of the Fiscal Council

Real wages have earlier fallen at times when a recession has been accompanied by uncertainty about the outlook for economic growth as in 2009, or by a faster recovery from recession than expected, as in 2010. In those years though, the labour market was adjusting not only through labour costs, but also through employment[4]. It is assumed in the short term that employment will grow and unemployment will remain at what is considered its natural sustainable level. It is uncertain though what the sales prices of output from companies will be, and how the cost of living will change. Average producer and consumer prices were both higher over the year by an estimated 20-30% in April-July 2022. The situation varied widely across sectors, and sales measured at current prices rose faster than consumer prices in less than one third of sectors. Neither employers nor employees have experience of negotiating under such circumstances.

Overall it should be expected that forecast errors will be larger than before over the coming year or year and a half.

[4] The average real wage fell by 2.8% in 2010. Economic growth was forecast at the time at close to zero and inflation was very low, at below 0.5% for most price indexes. The recovery of the economy was notably stronger though, and initial estimates put the nominal growth in yearly GDP at above 4%. An unpleasant surprise was the rise in the price of the consumer basket of 3% as a consequence of food prices on global markets. Real wages continued to fall also in the first half of 2011.

Background 2. *Recommendations from international organisations on easing the impact of inflation*

Experts from the IMF, the OECD and the European Commission emphasise in their policy advice the need to tame very high inflation and to cushion the impact of it on the most vulnerable households. Although the details of the emphasis and the advice vary, the general position is the same, that it is currently best in both the short and long-term perspectives to prioritise temporary measures in fiscal policy that are as well-targeted as possible. It is recommended that budget expenditures not increase excessively and that price signals that would increase demand for fossil fuels be avoided.

The OECD has considered ways of easing inflation more broadly[5]. The main conclusion is that although measures that directly affect the price of energy products such as tax cuts or price caps can be introduced quickly and cover all consumers equally, there are several drawbacks to them. Price caps do not encourage any reduction in demand or increase in supply if there is a shortage of energy supply. Tax cuts can have a high budgetary cost and might not translate into lower consumer prices, but rather larger profits for energy producers. This means that if prices remain high for a long time, as is currently forecast, support measures should be favoured that can offer more assistance in coping with high price levels. It is difficult to apply complex and well-targeted support measures if countries do not have enough information to identify those who need help.

The recent assessment by the OECD[6] found for Estonian fiscal policy that further spending should avoid stoking inflationary pressures by remaining tightly targeted to refugees and the most vulnerable, building defence capacity and investing in energy infrastructures. Support for low-income households to mitigate the negative impact of inflation on essential consumption needs should remain narrowly targeted.

The IMF also emphasised in its update to the world economic outlook published in July[7] that taming inflation should be the priority for policymakers. The general recommendations emphasise the need to support those who are affected most by inflation. On top of the direct rise in energy prices, it should be remembered that the tighter monetary policy needed to restrain inflation will have real economic costs, and so fiscal policy may need to soften the impact of that. If there is insufficient fiscal space available, such policies will need to be offset by increased taxes or lower government spending. The IMF recommended in its regular Article IV consultation[8] that Estonia should use the space available in its budget to cover the extraordinary expenses occasioned by the war, and also to help people cope with the leap in energy prices. It emphasised though that such help should in future be increasingly targeted to low-income households for the measures to be more effective.

The European Commission also recommends that countries ease the impact of high energy prices above all for the most vulnerable households[9], while being mindful of the measures' potential impact on inflation, the consistency with the long-term aim to reduce overall reliance on fossil fuels and shift fossil fuel imports away from Russia, as well as the need for prudence to maintain fiscal sustainability. The Commission consequently considers that policy measures aimed at addressing the increase in energy prices should be temporary and targeted at vulnerable households, for whom the energy bill represents a significant part of their consumption basket, as well as at specifically exposed industries. These measures should also be accompanied by incentives to increase energy efficiency and reduce fossil energy consumption.

[5] https://www.oecd.org/ukraine-hub/policy-responses/why-governments-should-target-support-amidst-high-energy-prices-40f44f78/
[6] https://www.oecd.org/economic-outlook/
[7] https://www.imf.org/en/Publications/WEO/Issues/2022/07/26/world-economic-outlook-update-july-2022
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[9] https://ec.europa.eu/info/system/files/2022_european_semester_spring_package_communication_en.pdf