EELARVENÕUKOGU

FISCAL COUNCIL

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

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Opinion

Russia's military invasion of Ukraine has made the economic environment very uncertain and forecasting it extraordinarily difficult. Inflation has been notably higher than was expected in spring, and so it has become one of the main risks to the outlook for the Estonian economy. Growth in the Estonian economy is also threatened by supply-side restrictions and general uncertainty.

In its opinion published on 6 September, the Fiscal Council did not endorse the summer forecast 2022 of the Ministry of Finance as it did not use the most probable assumptions about general government expenditures. High inflation made the assumptions for expenditures rapidly become out of date, which then affected all of the key macroeconomic indicators. The misleading impression could be given that a programme of reducing general government expenditures was under way that would cut general government spending as a ratio to GDP by several percentage points by the end of the forecast horizon. The Fiscal Council recommended in consequence that an updated macro forecast for 2022–2026 be attached to the state budget strategy that was being prepared for the end of September, and that it be based on the latest information about the planned budget measures of the new governing coalition.

The Ministry of Finance has followed this recommendation. The Ministry of Finance accompanied the state budget strategy with a new macroeconomic forecast scenario that takes account of the changed economic circumstances and the new coalition agreement. This mainly concerns expenditure measures that affect economic growth and the internal and external balance. Using the new expenditure assumptions makes the forecast more credible.

In summary the additional scenario for the macro forecast prepared to accompany the state budget strategy gives a sufficiently probable picture of the outlook for the Estonian economy in the coming years. The Fiscal Council consequently endorses the new macro scenario of the Ministry of Finance, and considers it an important input for further discussions about the state budget for next year and the budget strategy.

Chairman of Fiscal Council
Raul Eamets
Tallinn, 30 September 2022

Explanatory Report

Russia's military invasion of Ukraine has made the economic environment very uncertain and forecasting it extraordinarily difficult. It became clear by mid-summer that inflation remaining higher than expected meant that nominal growth had to be accounted for at around 10 percentage points higher than was assumed in the spring, and that consequent changes were needed for the main macroeconomic indicators. Such large changes had never previously happened between the forecasting rounds and the fiscal policy cycles connected to them. The question was raised under the extraordinary circumstances of how to handle those expenditures of general government that are not directly fixed in law at a time when circumstances are changing rapidly.

How general government expenditures are handled needs to be adapted to the circumstances

The Fiscal Council has not previously considered it a major shortcoming if the macro forecast is written using an unchanged fiscal policy and does not take account of possible changes that are highly likely but have not completed all of the decision-making procedures, or if the impact on the macro indicators of new revenue and expenditure measures that are passed after the macro forecast is initially drafted are not considered and they change only the general government fiscal position. Under normal circumstances the Fiscal Council had considered these to be minor methodological shortcomings that have no significant importance for the credibility of the macro forecast. This year the circumstances are different.

Table 1. Key indicators in the additional scenario

	2021	**2022**	**2023**	**2024**	**2025**	**2026**	**2022**	**2023**	**2024**	**2025**	**2026**
	Additional scenario						Difference from summer forecast				
real GDP growth (%)	8.0	1.0	1.0	2.8	2.4	2.0	0.0	0.5	−0.2	−0.1	0.0
nominal GDP growth (%)	14.5	16.0	7.5	3.9	4.1	4.1	0.0	1.7	−0.7	−0.3	−0.1
GDP at current prices (EUR billion)	31.4	36.5	39.2	40.7	42.4	44.1	0.0	0.6	0.3	0.3	0.2
CPI growth (%)	4.6	18.8	6.4	1.4	1.5	1.9	−0.7	−0.3	0.4	0.0	0.0
average wage (euros)	1 548	1 719	1 891	1 986	2 083	2 176	0	46	50	57	60
real average wage growth (%)	2.1	−6.5	3.4	3.6	3.3	2.6	0.6	2.7	−0.3	0.3	0.0
nominal average wage growth (%)	6.8	11.0	10.0	5.1	4.9	4.5	0.0	2.6	0.1	0.3	0.0
current account (% of GDP)	−1.6	1.5	1.1	1.4	1.8	2.1	0.0	−1.4	−1.3	−1.0	−1.0
contribution to growth											
domestic demand	6.3	−1.7	0.8	2.6	1.9	1.8	0.0	1.3	−0.2	−0.4	0.1
balance of goods and services	−0.7	2.6	0.2	0.2	0.5	0.2	0.0	−0.8	0.0	0.3	0.0
nominal budget balance (% of GDP)	−2.3	−2.7	−3.8	−3.3	−3.0	−2.9	0.0	−1.8	−1.6	−1.7	−1.7
structural budget balance (% of GDP)	−4.0	−2.6	−2.6	−2.6	−2.6	−2.6	0.0	−1.8	−1.6	−1.6	−1.8

Source: Ministry of Finance

Changes made in the additional scenario

The additional scenario (see Table 1) uses the draft of the state budget for 2023 and the fiscal policy decisions taken when the state budget strategy 2023-2026 was being written (see Appendix). This mainly concerns expenditure measures that affect the disposable income of residents of Estonia, domestic demand as a whole, and the internal and external balance. It also takes account of the measures taken to ease the impact on rising consumer prices of the rise in energy prices in 2022 and 2023[1].

Some 45% of the planned expenditure measures for 2023-2026 support domestic demand by raising the incomes of residents. The forecast assumes that the import content of the additional consumption by the private sector and the public sector will be larger than the average.

Other than the measures planned to compensate consumers for higher energy prices this year and in 2023 and the spending on helping Ukraine, the decisions taken increase the general government expenditures permanently. The level of general government current expenditure will be higher than it was before the coronavirus pandemic (see Figure 1).

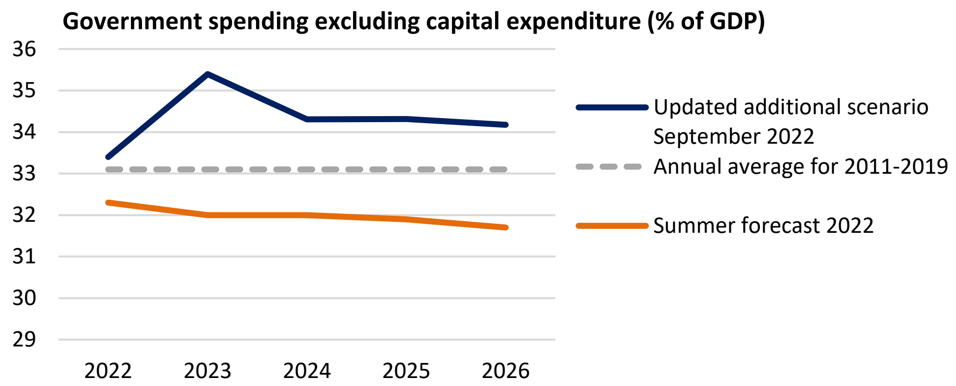

Figure 1. Change in the forecast for general government current expenditure

Sources: Ministry of Finance, Statistics Estonia

The higher general government spending than was in the summer forecast will start to raise the rate of growth in the economy in 2023. Later growth is slower than was forecast in the baseline scenario. These are reasonable changes that mainly reflect the additional government stimulus being larger in 2023 than in subsequent years. Changes in the other macro indicators are also in line with the new assumptions.

Risks to the forecast

The Fiscal Council highlighted several factors in its opinion on the summer forecast by the Ministry of Finance that will make macro forecasting notably harder in the coming years. The first is a substantial increase in the risks around the accuracy of external assumptions[2]. A second is that the rise in the price level means that the inflation figures have more impact than usual on economic processes and on how they are interpreted by decision-makers. This comes with the worry that the quality of the related statistics will deteriorate at a time of high inflation, making inflation even harder to forecast.

[1] It should be noted for CPI for 2022-2023 that not all the details of the measures taken to ease the rise in energy prices were known at the time the additional scenario was written.

[2] 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. From the viewpoint of the Ministry of Finance this can be considered imported information.

The main risk factor for the growth forecast is mainly related to inflation. The forecasts for real and nominal GDP growth made by various institutions also differ more than usual from one another. The forecast figures from the Ministry of Finance are generally around the average of those produced by other institutions (see Table 2).

Table 2. Forecasts of the growth and size of GDP by various institutions for 2022-2024

	2022	2023	2024	2022	2023	2024
	real GDP growth (%)			GDP (EUR billion)		
Ministry of Finance	1.0	1.0	2.8	36.5	39.2	40.7
IMF	1.2	2.2	3.8	35.1	37.9	40.4
Eesti Pank	–0.5	1.1	3.7	35.7	37.3	39.4
Swedbank	1.7	0.5	2.5	37.0	39.4	41.4
Luminor	0.0	0.0	4.0	37.0	40.0	43.0

Sources: Eesti Pank, IMF, Luminor, Ministry of Finance, Swedbank

The general uncertainty leads the Fiscal Council to consider that there is insufficient information available at the moment to forecast permanent changes in the structure of the economy. Better readiness to combat viral diseases, a probably permanently worse security situation, and demanding green transition goals all require additional spending from the government and the private sector, and this will probably slow growth in productivity at least in the short term. A change in the balance of demand and supply could in turn affect the rate of inflation and the development of the labour market.

The Fiscal Council recommends that future forecasts take care to analyse whether the labour market indicators match the expectations for them. Labour costs are forecast to increase faster than GDP in the coming years[3]. Investors should in consequence expect a smaller return on capital, while wages rising faster could start to make the exporting sector less competitive and so reduce the potential for growth in the economy. The level of the average wage is already more than 20% higher this year than it was before the pandemic. This rate of growth is feared to be faster than those in most of Estonia's trading partners[4].

In summary the additional scenario of the macro forecast of the Ministry of Finance is more credible than the summer forecast and is better suited for taking important decisions about economic policy.

[3] The Estonian economy stood out even in the decade before the pandemic for a longer cycle of increasing real unit labour costs (URLC) than in other European Union countries.

[4] There was no information available about the rise in wage costs in other European countries at the time that this opinion was written.

Appendix. *The revenue and expenditure measures in the state budget strategy for 2023-2026*

Measure	2022	2023	2024	2025	2026
	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
raising the tax-free minimum threshold to 654 euros	0.00	-0.21	-0.20	-0.18	-0.17
extending the current excise rates on fuel and electricity until 1 April 2024 and postponing the gradual rise	0.00	-0.04	-0.07	-0.10	-0.10
additional dividends (including additional income tax)	0.14	0.23	0.21	0.30	0.31
the European Peace Facility	0.00	0.00	0.13	0.19	0.00
other revenue measures	0.00	0.02	0.01	0.00	0.00
Revenue measures total	*0.14*	*-0.01*	*0.09*	*0.21*	*0.04*
rises in child and family benefits and indexing	0.00	-0.37	-0.39	-0.43	-0.44
additional funding for higher education	-0.02	-0.07	-0.11	-0.16	-0.21
transition to education in Estonian	0.00	-0.07	-0.06	-0.06	-0.06
reform of the funding of general care	0.00	-0.07	-0.10	-0.10	-0.10
measures to support household consumers of electricity, gas and heating	-0.28	-0.26	0.00	0.00	0.00
using CO2 funds to support household consumers of electricity, gas and heating	0.28	0.26	0.00	0.00	0.00
security costs (medium-range air defence, infrastructure, spending from the European Peace Facility)	0.00	-0.18	-0.47	-0.31	-0.32
additional interest expenses	0.00	-0.07	-0.10	-0.14	-0.18
keeping research and development costs at the level of 1% of GDP	0.00	-0.08	-0.03	-0.02	-0.05
increasing the payroll for target groups	0.00	-0.37	-0.35	-0.34	-0.33
additional spending on ICT	0.00	-0.11	-0.09	-0.08	-0.08
mitigating the rise in property operation and maintenance costs	0.00	-0.12	-0.07	-0.06	-0.06
help for Ukraine and support for refugees	0.00	-0.10	0.00	0.00	0.00
various investments, including changes to existing plans	0.02	-0.05	0.00	-0.03	0.00
reserves, including emergency and other expenses	-0.12	-0.22	0.04	-0.16	0.00
Expenditure measures total	*-0.11*	*-1.87*	*-1.73*	*-1.89*	*-1.84*
TOTAL	*0.02*	*-1.88*	*-1.65*	*-1.68*	*-1.79*

Source: Ministry of Finance