

The Estonian Economy

Why worry about wage growth?

- Wage growth accelerated again
- Not sustainable in the longer term
- Exports have to recover

Wage growth accelerated again

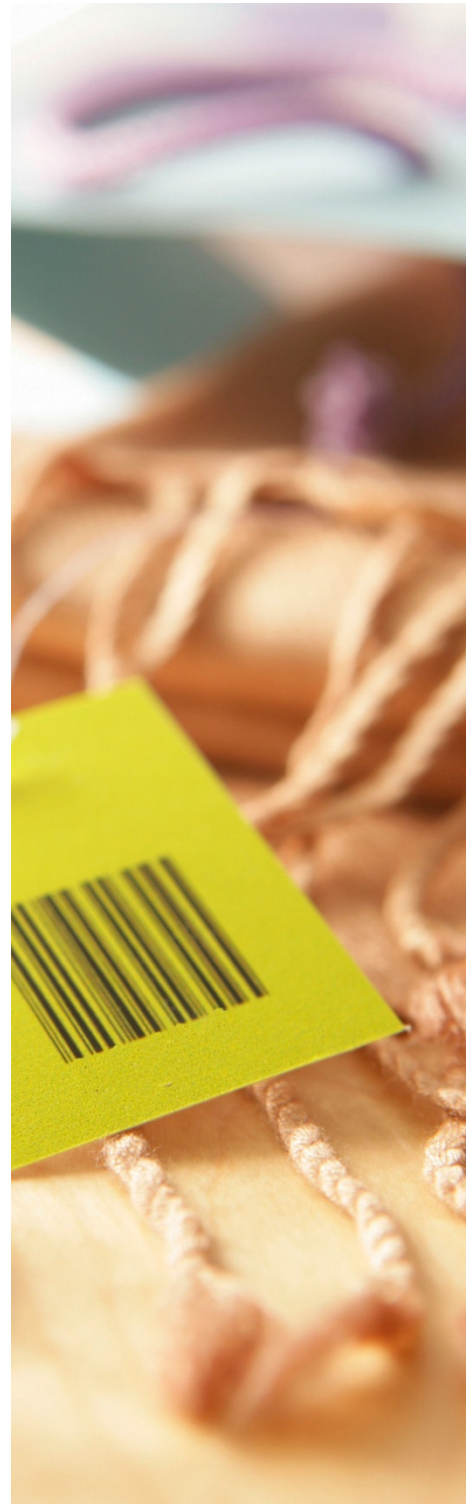
Gross wage growth has been around or above 5% since 2011. In the first half of 2015, wages increased in almost all sectors. Lower labour taxes and deflation will result in a remarkable surge in households' purchasing power this year. Fast growth in wages is, therefore, good news for companies that sell their products or services in the Estonian market. Strong consumption and wage growth has also supported tax revenues.

Not sustainable in the longer term

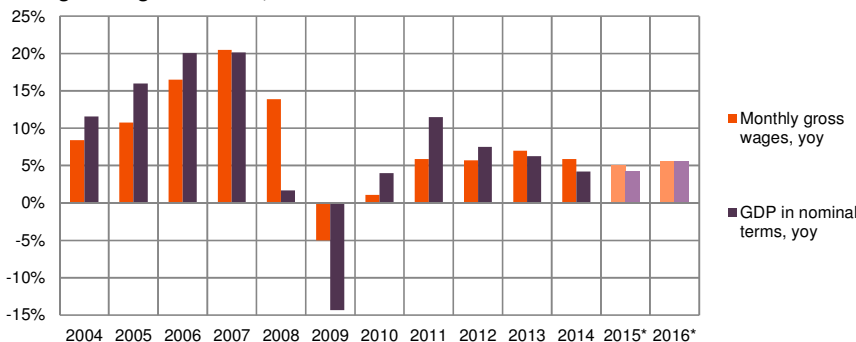
The labour market is tight; thus wage growth has been strong. Employees' bargaining power has grown, and this shows also in GDP figures; the share of labour income in GDP has grown and the share of profits has decreased. Enterprises' financial data also show that wage growth is not in line with changes in sales, profits, or productivity. Although the situation across sectors differs, companies' turnover and profits decreased in more than half of the sectors, while labour costs increased in most fields, in the first half of 2015.

Exports have to recover

Consumption-fuelled growth cannot last long. If export sales do not improve, the growth of wages (and consumption) will slow. While the EU's economy is gradually recovering, demand in some of Estonia's main export markets remains fragile. The economic situation in Russia is deteriorating, and the Finnish economy is barely growing. Enterprises' sales in Estonia are also dampened by lower output prices. Therefore, some sectors facing weak export demand and low output prices are finding it hard to keep up with the current wage growth.



Change in wages and GDP, nominal



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Why worry about wage growth?

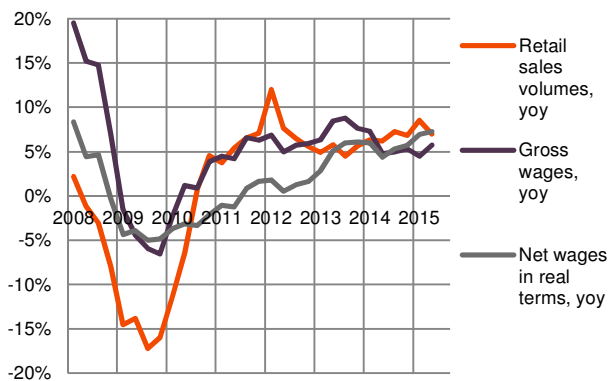
The labour market in Estonia is tight; thus wage growth has been strong. Unfortunately, wage growth rates have not been in line with changes in sales, profits, or productivity. Although the situation across sectors differs, companies' turnover and profits decreased in more than half of the sectors, while labour costs increased in most fields, in the first half of 2015. If export sales will not improve, the growth of wages and consumption will inevitably slow.

Wage growth accelerated again

The growth of monthly gross wages accelerated from 4.5% in the first quarter to 5.8% in the second quarter of this year. Monthly gross wage growth has been around or above 5% since 2011. In the first half of 2015, wages increased in almost all sectors, except for construction, which has been hit by low demand. Construction volumes have now fallen for two years. There could also be a technical reason for the fall in average wage level in the construction sector. After the introduction of an employees' registration obligation in July 2014, previously unofficially employed often became official workers with minimum wages, thereby dragging down average wage level in that sector. Therefore, without the registration obligation, average wage growth could have been even faster.

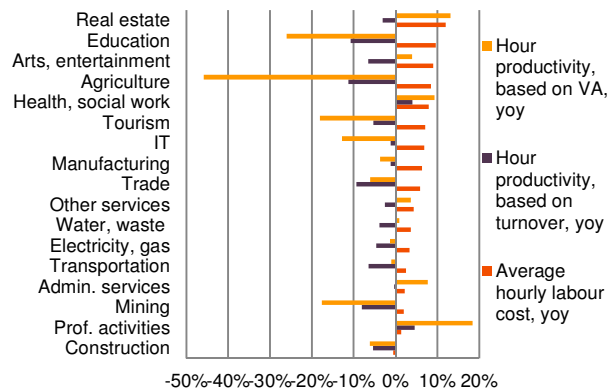
Average hourly wages increased the most in those parts of the private sector that sell their products and services mainly in the domestic market, where demand has been strong (such as real estate, entertainment, agriculture, and tourism). Wages also increased faster in parts of the public sector (education and health care), where the government has decided to lift wages to attract qualified labour. When, in the first half of 2015, average hourly wages increased in all sectors, except for construction, then productivity levels, based on either value added or turnover, moved in different directions.

Annual change in wages and retail sales



Source: Statistics Estonia, European Commission

Labour costs and productivity (H1 2015)



Source: Statistics Estonia

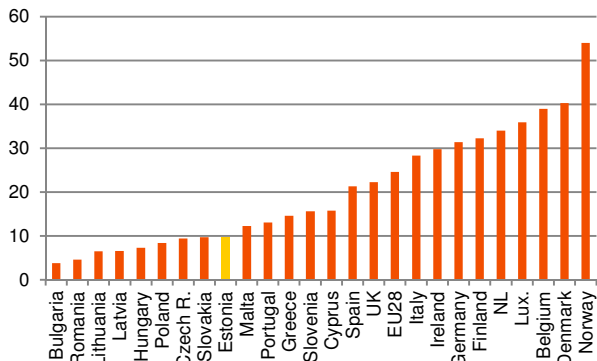
Lower labour taxes and deflation will result in a remarkable surge in households' purchasing power this year. Net wages were up by 7.1% in real terms in the first half of the year. Fast growth in wages is, therefore, good news for companies that sell their products or services in the Estonian market. Retail sales have grown very fast in Estonia. During the first seven months of the year, retail sales' volumes were up by 7.9% over the corresponding period of the previous year. Strong consumption and wage growth has also supported tax revenues (during the first eight months, +7.3% over the corresponding period of the previous year).

Wages are still quite low compared with Western Europe

Although the growth of labour costs in Estonia has been rather fast since 2000, one should note that this is part of a normal convergence process whereby wages in Eastern Europe have been growing faster than in Western Europe, where wages are (and have been) much higher. Hourly wages increased by 3.4 times in Estonia and by 1.5 times in the EU28, on average, between 2000 and 2014. Estonia's labour costs rose from 17% of the EU28's average in 2000 to 40% of that average in 2014. Still, in 2014, the average hourly labour cost was estimated at EUR 32.3 in Finland, EUR 24.6 in the EU28 as a whole, EUR 9.8 in Estonia, and EUR 6.6 in Latvia. According to the Statistical Office of Estonia, in the second quarter of 2015, 21,000 Estonians were employed abroad (3.3% of total employed), of which

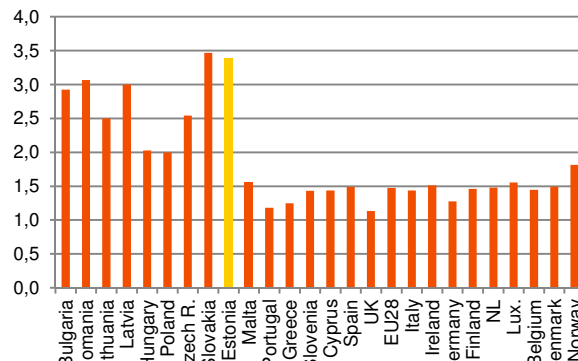
14,000 worked in Finland. Estonia's physical and cultural proximity to Finland, where the wage level is several times higher, is clearly one of the reasons why wages keep growing fast in Estonia. Estonia's labour productivity per hour worked¹ increased from 25% of the EU28's average in 2000 to 36% of that average in 2013, i.e., less than labour cost per hours worked.

Labour costs per hour in EUR in 2014



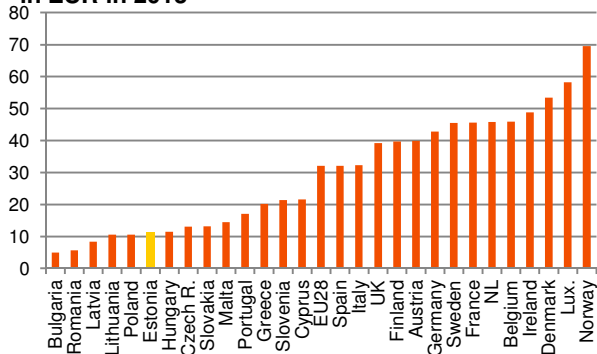
Source: Eurostat

Growth in labour costs from 2000 to 2014



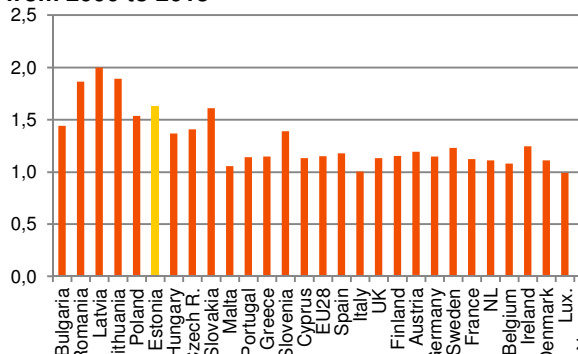
Source: Eurostat

Labour productivity per hour worked in EUR in 2013



Source: Eurostat (2012 data for Malta and Luxembourg)

Growth in labour productivity from 2000 to 2013

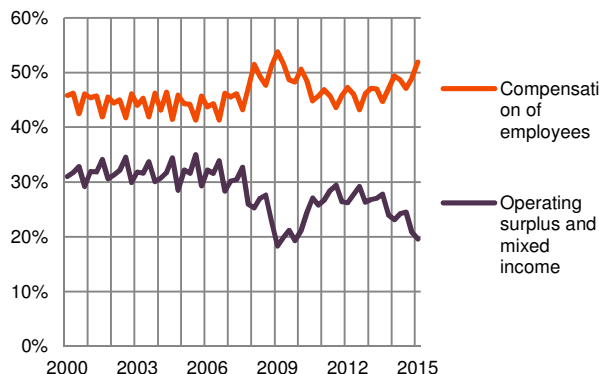


Source: Eurostat (Malta 2000-2012 and Lux 2002-2012)

Current wage growth rate is unsustainable

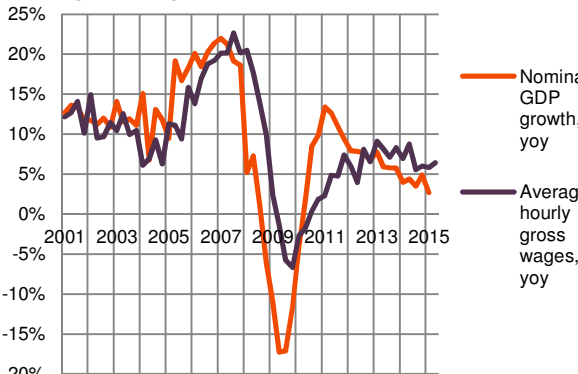
Wages have grown faster than nominal GDP since the beginning of 2013. Since the beginning of 2015, the gap between the two has widened even more. Employees' bargaining power has grown, and this shows also in GDP figures: the share of labour income (compensation of employees on the graph) in GDP has grown, and the share of operating surplus (a proxy for companies' profits) in GDP has decreased.

GDP by income (share in GDP)



Source: Statistics Estonia

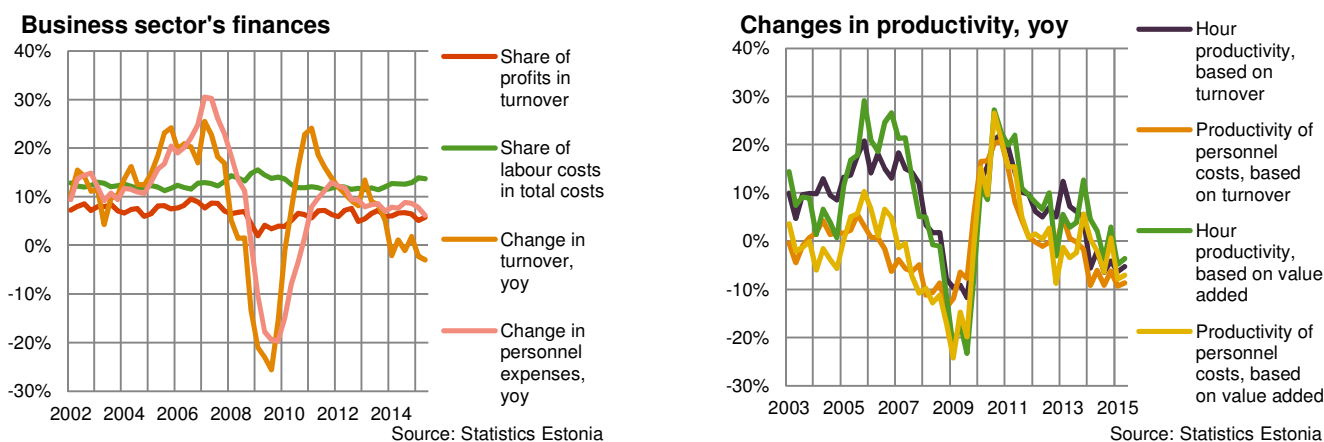
Change in wages and GDP



Source: Statistics Estonia

¹ Labour productivity per hour worked is calculated as real output (deflated GDP measured in chain-linked volumes, reference year 2005) per unit of labour input (measured by the total number of hours worked).

Enterprises' financial data also show that wage growth is not in line with changes in sales or profits (-2.7% and -15.9%, respectively, in first six months of 2015, year on year). Although the growth of personnel expenses slowed in the first half of 2015, the share of labour costs in total costs grew from 11.7% in 2013 to 12.7% in 2014, and to 13.8% in the first half of 2015. At the same time, the profitability of companies has been decreasing due not only to weak sales abroad but also to higher labour costs.



Labour productivity² has been decreasing in recent quarters, according to enterprises' financial data. And although the situation across sectors differs, companies' turnover and profits decreased, in the first half of 2015, year on year, in more than half of the sectors, while labour costs increased in most fields. There were only two sectors where personnel expenses' share in total costs did not increase: construction and education.

Annual change in enterprises' turnover, costs and profits in the first half of 2015

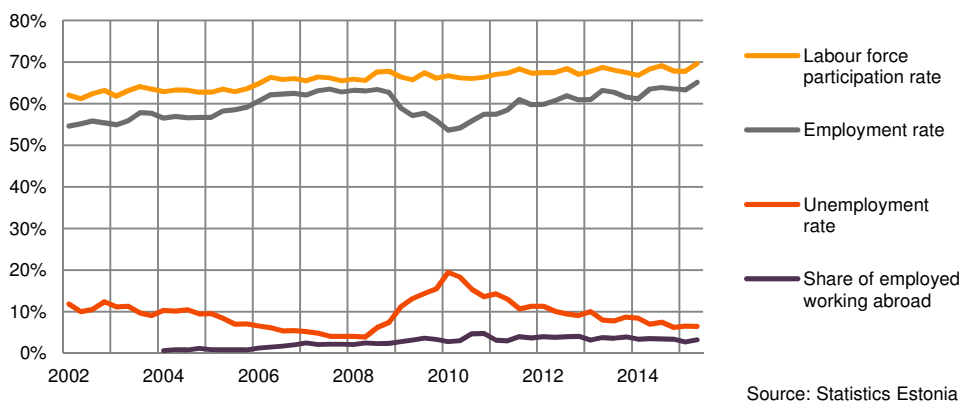
	Number of employees	Turnover	Costs	Personnel expenses	Profit (loss)	Share of profit (loss) in turnover, H1 of 2015
TOTAL	3%	-3%	-2%	7%	-16%	5%
Agriculture, forestry and fishing	-1%	-13%	-4%	-2%	-390%	-7%
Mining and quarrying	0%	-10%	-3%	2%	-52%	7%
Manufacturing	5%	3%	4%	8%	-18%	5%
Electricity, gas	-3%	-7%	-7%	4%	-7%	12%
Water supply	-6%	-9%	-10%	-6%	-5%	11%
Construction	11%	7%	7%	6%	1%	2%
Trade	2%	-6%	-5%	6%	-19%	2%
Transportation and storage	3%	-4%	-4%	6%	-5%	7%
Tourism	10%	3%	13%	17%	-102%	0%
ICT	2%	-4%	5%	8%	-85%	1%
Real estate activities	-3%	-10%	-22%	10%	5%	52%
Professional, scientific activities	-5%	2%	-3%	5%	46%	13%
Administrative activities	0%	1%	0%	8%	13%	11%
Education	-5%	-16%	0%	-1%	-76%	6%
Health and social work	15%	11%	12%	20%	5%	10%
Arts, entertainment	3%	3%	2%	5%	23%	6%
Other services	3%	-10%	-8%	3%	-22%	9%

Source: Statistics Estonia

² Hour productivity on the basis of turnover = turnover / hours worked. Productivity of labour costs, based on turnover = turnover / labour costs. Hour productivity, based on value added = ((turnover - total costs) + labour costs) / hours worked. Productivity of personnel costs, based on value added = ((turnover - total costs) + labour costs) / labour costs.

Estonia's labour market is tight; thus wage growth has been strong. The working-age population is decreasing, the employment rate is already high, and the unemployment rate has fallen to a level where a further decrease is increasingly difficult. The labour market tightened further in the second quarter. Employment increased, while the number of inactive and unemployed declined, compared with last year. Some cracks have started to emerge in the market, however. Seasonally adjusted figures show a slight increase in the unemployment rate in the second quarter. The number of people who have recently become unemployed, has also grown since March.

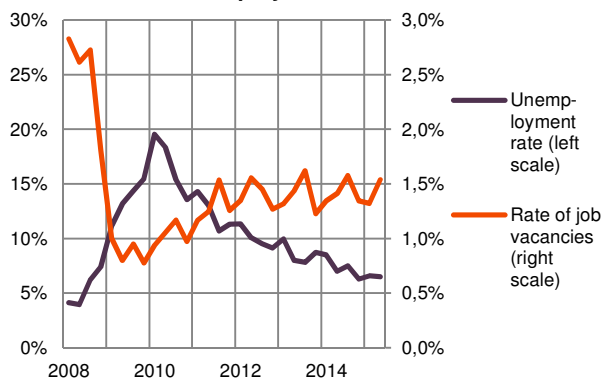
Labour market indicators



Source: Statistics Estonia

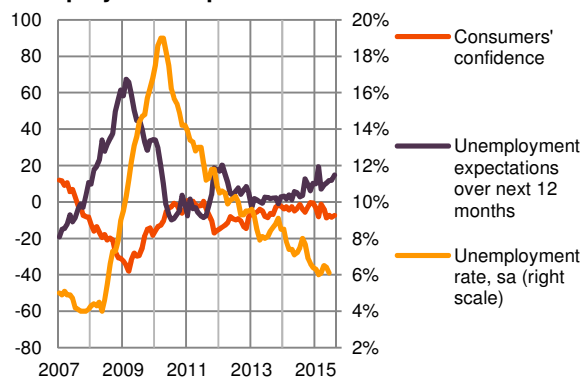
The rate of job vacancies (1.5% in the second quarter of 2015) in Estonia has been low and stable since 2011. Estonia's labour market is more flexible than the EU's average, and the unemployment rate has fallen steadily even when the vacancy rate has not changed much. The vacancy rate is a bit higher in IT and finance, where the average wage is the highest, and also in some service sectors where the average wage is much lower than average – public administration, other administration and supportive services, tourism, and domestic trade. Interestingly, even as the unemployment rate has been falling steadily, workers have, since 2014, become more insecure about their jobs.

Vacancies and unemployment rate



Source: Statistics Estonia

Unemployment expectations



Source: European Commission, Eurostat

Recent wage growth rate will continue if exports recover

Consumption-fuelled growth cannot last long. If export sales do not improve, the growth of wages (and consumption) will slow. While the EU's economy is gradually recovering, demand in some of Estonia's main export markets remains fragile. In 2016, the economic situation in Russia will deteriorate, and the Finnish economy will show only modest growth. Estonia's sales are also dampened by lower output prices. Some sectors facing weak export demand and low output prices are finding it hard to keep up with current wage growth.

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