

The Estonian Economy

Estonian enterprises need to put more effort in to improve their productivity growth

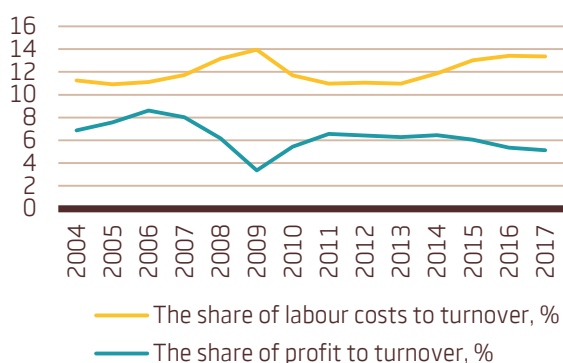
- ▶ In a post-crisis period, the growth of Estonian labour productivity has been weak
- ▶ Estonian labour productivity is lower than majority of European Union member states
- ▶ Estonia is losing price competitiveness against main trade partners

After the recovery from the financial crisis, the growth of Estonian labour productivity has been weak, while labour costs are growing. The growth of productivity dropped rapidly when the economy was hit by the financial crisis and never regained the same pace of growth – between 2002 and 2007, average hourly productivity growth was 6% in real terms, whereas between 2012 and 2017 average hourly productivity was only 2% in real terms. In the past 15 years, Estonian labour productivity has strengthened compared with the European Union member countries' average; however, in the post-crisis period, the growth of productivity compared with other member states has moderated. Due to growing labour costs and low productivity growth, Estonian enterprises have been losing price competitiveness against their trade partners, although they have managed to slow this pace a bit. Even though, theoretically, Estonian companies are losing their price competitiveness, they have gained market shares in most of their main trade partners' markets (Germany, Sweden, Finland, Latvia, and Denmark); at the same time, however, the growth of their profits has slowed or even decreased. Estonian enterprises should pay more attention to productivity growth; otherwise, they will lose their international price competitiveness and should accept smaller profits, as it will be difficult to adapt to growing labour costs. Thus, enterprises should invest more in automatisisation of work processes, new and faster technologies, employee training, and efficiency of the supply chains to improve the level of productivity and reduce costs of production, in order to boost the share of value added in turnover.

Economist:

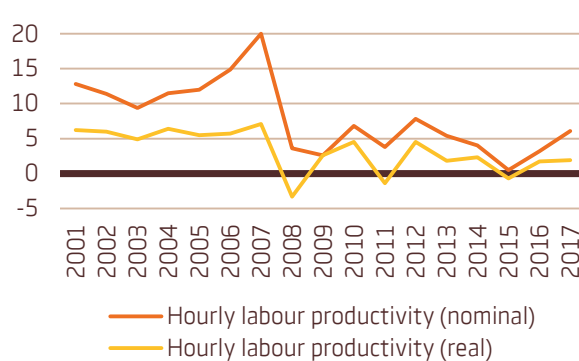
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Business sector profitability and personnel expenses



Source: Statistics Estonia

Hourly labour productivity growth Change, Y/Y



Source: Statistics Estonia

Growing labour costs are challenging for enterprises

In recent years, the Estonian labour market has tightened – the unemployment rate is the lowest since the last financial crisis, whereas the employment rate is historically high and the average gross wage has almost doubled in the last 10 years. The rapid wage growth was supported by the shortage of labour, and it will remain quite high as labour demand increases more than labour supply. Despite the improved economic activity and favourable situation in the labour market for employees, growing labour costs are challenging for enterprises.

Business sector profitability is declining

Estonian enterprises are more and more facing growing labour costs, which have reduced their profitability. Whether companies can overcome high labour costs and increase profitability will depend on how they improve their productivity. The growth of productivity will enable companies to adopt to the shortage of labour, increase their profits, and pay higher wages. In the long run, productivity growth should also outpace the growth of labour costs; otherwise, Estonian companies will lose their international price competitiveness.

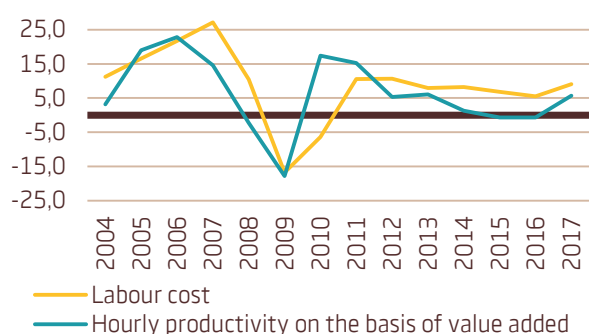
Over the last five years, the share of personnel expenses in total costs of the business sector has grown by almost 20%, which is much higher growth than before the financial crisis. To compare, the share of personnel expenses in total costs grew by 12% between 2003 and 2008. In the last two years, the share of labour costs in turnover was one of the highest in this millenium – 13,4% in 2016 and 2017. However, this growth has slowed. This ratio was slightly higher only in 2009 (13,9%), when enterprises couldn't adjust fast enough their labour costs to the reduced turnover.

Estonian enterprises' profitability, measured as the share of profit in turnover, has been decreasing for three years in a row. Over the last five years, the growth of business sector profitability has been weaker than before the financial crisis. Estonian companies' profitability has fallen to historically low levels, excluding the impact of the financial crisis in 2009.

Losing price-based competitiveness against main trade partners

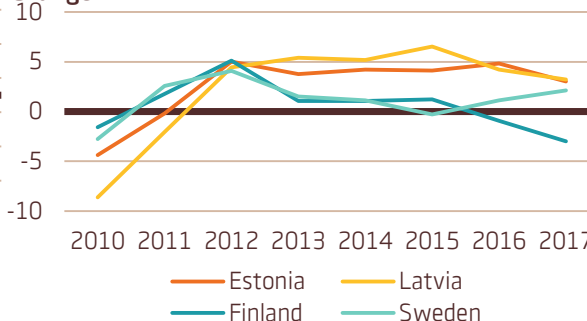
The growth of labour costs has been outpacing productivity growth for the last five years, but the gap between them is slowly decreasing. Due to growing labour costs and low productivity growth, Estonian enterprises have been losing their price competitiveness against trade partners; nevertheless, they have managed to slow this pace a bit. Even though, theoretically, Estonia is losing price competitiveness,

Labour cost and labour productivity
Change, Y/Y



Source: Statistics Estonia

Unit labour cost based on hours worked
Change Y/Y



Source: Eurostat

Estonian enterprises have gained market shares in most of their main trade partners' markets (Germany, Sweden, Finland, Latvia, and Denmark); at the same time, however, the growth of their profits has slowed or even decreased.

Thus, in a situation, where labour costs are growing, Estonian enterprises should pay more attention to productivity growth; otherwise, they should accept smaller profits, as it will be difficult to increase their export market shares.

Productivity is lower than majority of European Union member states

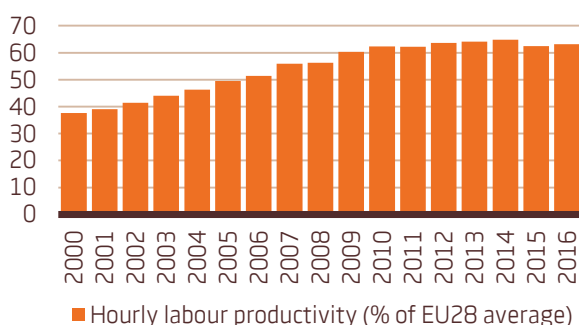
Estonia, as well as other European countries, is confronting demographic problems – a decreasing and ageing population – leading to a diminishing labour force. If the decline in the labour force continues, it will have a negative effect on economic output. Thus, in a situation of a diminishing working-age population and growing labour costs, the economic growth of a country depends largely on the growth of productivity and the development of technology.

The growth of productivity¹ dropped rapidly when the economy was hit by the financial crisis and never has regained the same pace of growth – between 2002 and 2007, average hourly productivity growth was 6% in real terms, whereas between 2012 and 2017 average hourly productivity was only 2% in real terms.

In the past 15 years, Estonian labour productivity has strengthened compared with the European Union member countries' average. Estonian labour productivity, measured as a percentage of the European Union average, rose from 38% of the EU28 average in 2000 to 63% of the EU28 average in 2016. However, over the last few years, the growth of productivity compared with other member states has moderated as, after the crisis, the growth of the Estonian economy has been supported more by the growth of employment (after the crisis, the difference between economic growth and the growth of employment has decreased).

In 2016, Estonia was in 21st place among European Union member states in hourly labour productivity. Compared with previous years, Estonia's position has strengthened, but the country is still lagging behind the majority of the member states.

**Estonian hourly labour productivity
% of EU28 average**



Source: Eurostat

**Hourly labour productivity in 2016
% of EU28 average**



Source: Eurostat

¹ Labour productivity per hour worked is calculated as real output (deflated GDP measured in chain-linked volumes; reference year 2010) per unit of labour input (measured by the total number of hours worked).

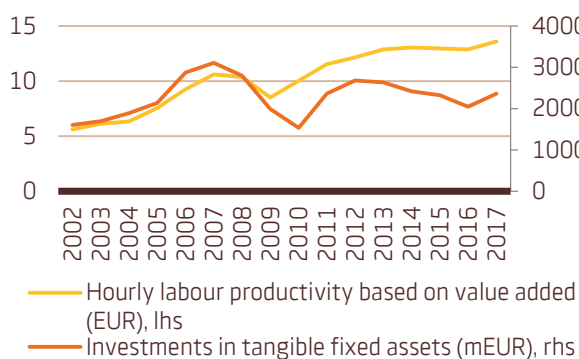
Companies need to put more effort in to improve their productivity growth

In the post-crisis period, the growth of Estonian business sector productivity, measured as a ratio of hours worked to value added, has been weak. Estonian companies' productivity growth in nominal terms was 90% between 2002 and 2007, but only 36% between 2010 and 2017. The productivity of a business sector largely depends on investments, which declined for four years in a row, from 2013 to 2016. In this period, the growth of productivity also slowed and was even negative in 2015 and 2016 (-0,6 and -0,7, respectively). Although, in 2017, investments increased by 15% and productivity picked up by 6%, companies should still invest more in automatisisation of work processes, new and faster technologies, employee training, and efficiency of the supply chains to improve their productivity and adapt to growing labour costs.

Economic growth in recent years was supported mostly by the services sector (i.e., ICT; professional, scientific, and technical activity; and transportation and storage). The economy is orienting more towards service activities, where the share of value added in turnover is larger than in the industrial sectors. Nevertheless, the share of manufacturing in the total economy is the largest among all economic activities. The growth of the manufacturing sector's turnover and value added depends largely on foreign demand, as companies in this industry export about 70% of their turnover. In the post-crisis period, investments of the manufacturing sector have been slowly increasing, while the sector's productivity growth has been weak and remained below the national average. Thus, growing demand has been served more by the higher number of employees. At the same time, in some capital-intensive industries, such as manufacturing of paper and manufacturing of chemicals, productivity was higher than the average productivity of the manufacturing sector.

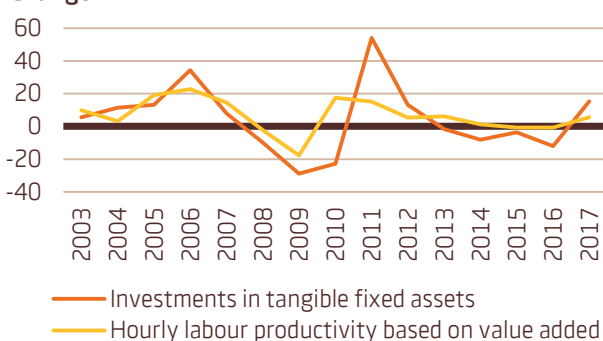
In 2017, the highest productivity was in the energy sector (EUR 34,2), where it was more than two times higher than the average productivity of all economic activities (EUR 13,6). In the post-crisis period, the growth of the share of value added in turnover in the energy sector was highest among sectors; meanwhile, the share of value added was only slightly larger than the average of all activities and remained at almost the same level as in 2005. In 2013, productivity picked up by almost 50% in only a year and reached the peak of the sector's productivity (EUR 41,7); this was also supported by lower employment and outstandingly high investments. Since then, the productivity of the sector has been decreasing.

Productivity and investments



Source: Statistics Estonia

Productivity and investments
Change Y/Y



Source: Statistics Estonia

In 2017, higher productivity than the average of all economic activities was also in real estate (EUR 32,4), mining (EUR 19,6), information and communications (EUR 18,8), professional, scientific, and technical activities (EUR 14,8) and wholesale and retail trade (EUR 13,8). These sectors also had a larger share of value added in turnover than other economic activities.

Although, in 2017, the productivity of the real estate sector was second highest among sectors, in the last seven years, the growth of productivity was weaker than the national average. In 2015, the productivity of the real estate sector (50,8) was at a record high. The growth of productivity in the real estate sector was supported more by the low-interest-rate environment, growing demand, and rising housing prices than by an improvement of brokers' sales efficiency. Such productivity growth is not sustainable in the long run – in the last two years, the productivity of real estate sector has already started to decline.

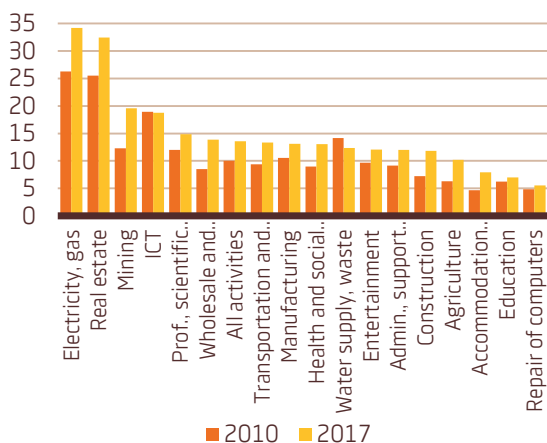
One of the largest shares of value added in turnover among industrial sectors is in mining. In 2017, the share was even larger than in 2005. In the post-crisis period, the growth of labour productivity in mining was one of the highest among sectors; meanwhile, the productivity of the sector was also higher than the average productivity of all economic activities. Last year, the productivity of the sector was one of the highest in two decades. The productivity was higher only in 2014, when it was supported by higher investments and lower employment.

Between 2010 and 2017, the growth of productivity was weaker in all sectors, except transportation and storage, than between 2002 and 2007. Thus, in the post-crisis period, the growth of productivity even in the sectors with the highest productivity was weaker than before the crisis. Although, in the post-crisis period, the highest growth of productivity was in agriculture and forestry, accommodations and food, wholesale and retail trade, and construction, productivity in these sectors has been below the average of all economic activities (productivity of wholesale and retail trade was only slightly higher than the national average for the last two years).

Conclusions

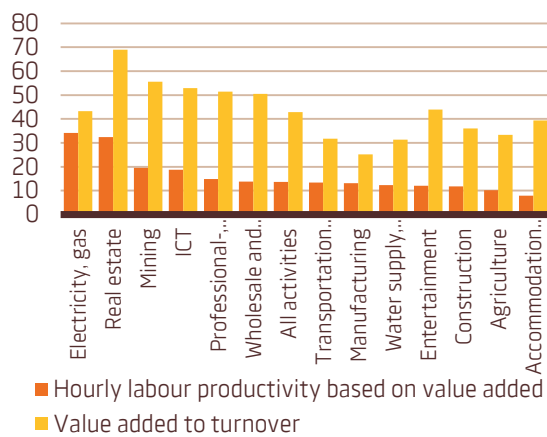
After the recovery from the financial crisis, the growth of business sector productivity has been weak, while labour costs are rapidly growing. Enterprises should invest more in automatisisation of work processes, new and faster technologies, employee training, and the efficiency of the supply chains to

Hourly labour productivity based on value added EUR



Source: Statistics Estonia

Hourly labour productivity based on value added euros



Source: Statistics Estonia

improve the level of productivity and reduce costs of production, in order to improve the share of value added in turnover. Otherwise, enterprises will lose their international price competitiveness and should accept smaller profits, as it will be difficult to adapt to rapidly growing labour costs.

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