Eesti Pank
Bank of Estonia

Estonian Economy and Monetary Policy

1/2008

From this issue onwards, Eesti Pank will be publishing its overview of Estonia's current and expected economic situation in a slightly different form and with a new title. The previous *Monetary Policy Survey* is now titled as *Estonian Economy and Monetary Policy*, which will also be published twice a year – in spring and autumn. The overview includes analyses of current economic developments as well as the central bank's forecasts for coming years.

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INTRODUCTION

After the accession to the European Union, the inflow of private capital into Estonia increased abruptly, exceeding even the most daring forecasts. The growth rates of real estate investment and to a lesser extent also private consumption reached levels that cannot be considered sustainable in the longer run. Another driving force behind growth was the strong demand on the main export markets.

In summer 2007, the expected slowdown in economic growth started. This is primarily caused by lower investment activity in the real estate sector and the declining growth of private consumption. The cooling of the economy has been even faster than expected in the autumn forecast of Eesti Pank. The reason lies with the weaker-than-expected external demand, higher global prices of food and other raw materials and greater uncertainty in the real estate sector.

Compared to the previous autumn, the external environment has become considerably more unfavourable for the Estonian economy. Growth indicators are heading down in several major countries and the situation will probably not improve in 2009 either. External price pressures have also increased, which has reduced the purchasing power of consumers. The spring forecast of Eesti Pank curbed the growth rate of domestic demand for several reasons. First, the decrease in investment arising from the cooling of the real estate sector is more extensive. Second, higher inflation rate and the increasing uncertainty of households have reduced consumption growth.

In the forecast base scenario, Eesti Pank expects the growth to be 2% this year and 3% and 5%, respectively, in the next two years. The speed of economic recovery depends on Estonia's success in the utilisation of the existing export potential. In order to do this, the so far domestic demand oriented resources should be partly redirected to the export sector. The continuous support of the financial sector to the financing of new export-oriented business projects is also important.

The slowdown of growth did not immediately bring along a lower inflation rate. In autumn, the consumer price increase was boosted by the rise in oil and food prices on the world market, complemented by administrative measures at the beginning of 2008. Although compared to 2007, this year the inflation will grow faster than average, the first half-year of 2008 will witness the start of a longer-term downward trend in price growth. The forecast base scenario of Eesti Pank expects the inflation to be 9.8% in 2008, 4.5% in 2009 and 3% in 2010. The external balance is also expected to improve further over the forecast horizon owing mainly to cyclical factors.

General government can support economic adjustment most efficiently through a prudent fiscal policy. This is essential for supporting smooth adjustment of the economy and improving credibility to ensure further external financing. To maintain budget balance, the expenditure planned for the period of stronger growth should be reduced. Another precondition for sustainable and rapid economic recovery is the continuation of economic policy measures that support market flexibility and productivity growth.

I. ESTONIAN ECONOMY IN 2007

The adjustment of the Estonian economy started with the support of domestic demand in the middle of 2007. Therefore, the developments in the first and second half-year were different in many ways. Expectedly, the first signs of adjustment revealed themselves in the slowdown of economic growth. Lower investment activity and slower growth in private consumption reflected clearly also in the decreased trade deficit. The decline in labour costs and domestic price pressures manifested itself somewhat later.

MONETARY POLICY ENVIRONMENT

Considering the growing inflation pressures, the European Central Bank (ECB) continued raising monetary policy interest rates in the first half of 2007. The uncertainty arising from risky housing loans issued by the US banks spread all over the world in August and influenced also the rise of the Euribor. In Estonia, the prices of housing loans increased by 1.8 and long-term corporate loans by 1.2 percentage points by the end of the year. This together with the prospects of decelerating economic growth reduced loan demand and accelerated the slowdown in credit growth that had started already in the middle of 2006.

The real exchange rate of the Estonian kroon appreciated mostly due to dollar depreciation, reaching an average of 0.9% year-on-year.

As a result, the **monetary policy environment** was more **restrictive** in 2007 than in earlier years, although capital inflow was still high and the growth of monetary reserves continued.

MONEY AND CAPITAL MARKET

The turmoil that struck global financial markets last summer increased investors' risk aversion. In the case of Estonia, this was further exacerbated by the fact that the majority of macroeconomic balance indicators improved modestly until the end of the year and that the press published several articles discussing the possibilities of the devaluation of the Estonian kroon.

In such environment, risk-hedging transactions related to the kroon exchange rate gained popularity. This led to an increase in the kroon's money market interest rates in the second half of November. At the beginning of 2008, the upward trend turned but Talibor quotations remained at a much higher level than seen in recent years. At the end of January, the differences between interest rates across the maturity spectrum of three, six and twelve months were approximately 30, 35 and 40 basis points, respectively.

In the first half of November, the stronger demand for risk-hedging transactions related to the kroon exchange rate caused an increase in the difference between interest rate quotations that form the basis of future Estonian kroon and euro transactions (forward premiums). Quotations of forward transactions remained high and volatile until the end of the year. However, in January the derivatives market started to show signs of cooling since the quotations of forward transactions fell.

The end of the construction boom and the decreasing growth rate of private consumption inhibited growth in money demand in the second half-year. The increased interest rates had a similar impact. By the beginning of 2008, the interest rate on corporate kroon loans had risen to 6.6% and that on household housing loans to 6.2%.

Borrowing activity decreased steadily and by the end of the year, the size of loans granted to the non-financial sector had increased just about 30% on an annual basis. This trend continued also in the first months of 2008. The stock of consumer credit grew faster than average but displayed clear signs of a slowdown.

At the end of December, the stock of bank loans granted to the non-financial sector accounted for 90% of GDP; housing loans comprised 36% of that. It can be said that in the second half-year, financial deepening almost ceased and only the exporting sector continued to borrow at the usual rate.

Despite the decreasing demand, foreign capital inflow was large also in the second half of 2007 and monetary reserves continued to grow. The inflow of foreign direct investment in the non-financial sector was slightly higher than in the past few years. The majority (about 70%) of direct investment in Estonia were reinvested earnings. Similar to previous years, most of the external funds were raised in the form of loans and the stock of external debt increased to 110% of annual GDP by the end of the year.

EXTERNAL DEMAND

Growth in the partner countries remained relatively strong but did not pick up further or exceed expectations as in earlier years. Therefore, the exports of goods and services also maintained rapid growth in 2007.

The increase in goods exports was still broad-based. The exports of electronic products, timber and timber products and food products grew faster than average. The conditions for the sale of dairy products as well as other food products were very good. However, the slowly increasing production capacity of domestic agriculture became a restricting factor. The lack of raw material inhibited also growth in exports of timber products.

Exports of services increased considerably faster than in 2006. Transport services, especially maritime transport and construction, made the biggest contribution to growth. In tourism business growth remained modest.

Based on general indicators, growth in services exports was much stronger compared to goods exports. At constant prices, exports of services increased 8% year-on-year, while exports of goods remained virtually at the previous year's level. However, these indicators are not entirely comparable. To be more explicit, in 2006 the growth of merchandise exports was accompanied by a considerable increase in the re-export type of goods that contribute only marginal value added for the Estonian economy. In 2007, the flow of such goods did not grow any longer, and their value even decreased. This, however, might lead to the wrong conclusion that growth in Estonia's export sector has slowed significantly. The competitiveness of goods produced in Estonia and their contribution to economic growth is better characterised by the export dynamics of manufactured goods. According to this indicator, the growth rate of goods exports in 2007 was only 1–2 percentage points lower than in the previous year.

ADJUSTMENT OF DOMESTIC DEMAND

The extremely rapid economic expansion in 2005-2006 relied mainly on the developments in the real estate sector. In spring 2007, the robust growth started to slow as expected.

Real GDP growth that had reached 9% in the first half-year decreased to around 5% in the second half. According to preliminary estimates, the annual average growth rate was 7.1%. Thus, economic growth slowed to the levels recorded prior to the EU accession. Expectedly, growth decreased above all in fields related to real estate development. In the second half-year, growth in these sectors decelerated considerably and practically ceased in the last quarter. The construction sector witnessed a smaller decline owing to the continuation of the ongoing development projects.

Investment activity decreased significantly in the second half of 2007, while the amount of fixed investment remained unchanged compared to 2006. The decline in investment activity resulted from real estate related developments, whereas in export-oriented fields, for instance, there were no changes. The rapidly decreasing growth rate overshadowed the fact that compared to the old EU member states, investment demand remained high and required continuous external financing.

Private consumption was another component of domestic demand that sustained the robust growth of previous years and started to grow slower in summer 2007. By the last quarter, the earlier double-digit real growth rate had decreased to 3–4%. Government consumption growth, on the other hand, picked up speed but was still below the average level of economic growth and did not exceed 5% at constant prices.

According to preliminary estimates, the growth rate of private consumption stabilised at the beginning of 2008, whereas investment activity declined further.

EXTERNAL BALANCE

Along with the start of economic adjustment, the deterioration period of the current account deficit came to an end in summer 2007. When domestic demand growth slowed, imports of goods decreased, which had a positive impact on trade balance.

In the first half-year when the growth rate of domestic demand still exceeded 12%, the current account deficit accounted for about 19% of GDP of the period. It was over 3 percentage points more than at the same time in 2006. In the second half-year, the growth of domestic demand at constant prices slowed to 6.3% and also the external trade deficit started to decrease. As a ratio of GDP, the external trade deficit was similar to that of the same time last year. Flash estimates of the first months of 2008 referred to the continuous decrease in the deficit.

Supported by freight growth and construction, the growth of services exports picked up significantly; however, the amount of imported services also started to increase faster. Similar to last year, the cost of exported services exceeded that of imported services by slightly more than 6% as a ratio of GDP. Thus, the services sector remained neutral as regards the improvement of external balance, and the main determinant was imports of goods, driven by domestic demand.

Although the trade balance deficit decreased in the second half-year, this did not reduce the total current account deficit. The underlying reason for this was the increased outflow of investment income, calculated on an accrual basis. Income on investment in Estonia was about 45% larger than in 2006 also in the last months of 2007. This was at least partly related to the prices of services, which had been going up until the end of 2007, as well as to the fact that economic adjustment first reveals itself in the decrease of the growth rate and only then in the decrease of domestic price pressures. Therefore, the annual current account to GDP ratio was even worse in 2007 than in the previous year, standing at nearly 17%.

INFLATION

Similar to the past few years, **consumer price growth was stronger than expected** also in 2007. As an annual average, the cost of consumer basket increased 6.6%.

As long as the period of rapid growth lasted, the robust increase in service prices continued as well. Housing costs grew also due to the increase in the value added tax imposed on district heating and the rise in world energy prices. In the light of the weakening domestic demand, the acceleration in core inflation also ended in the last months of the year. Unfortunately, a **hike in food prices on the world market** started off then. At the end of the

Table 1. Key economic indicators of the two periods of robust growth in Estonia

	1995–1998 Average	1998	1999 Year of recession	2000–2007 Average	2007
Real GDP growth (%)	6.4	5.4	-0.1	8.6	7.1
Real export growth (%)	11.5	13.7	0.6	10.8	1.5
Consumer price index (%)	17.9	8.2	3.3	4.1	6.6
Growth of average gross wages (%)	24.5	15.4	10.4	12.5	20.4
Current account (% of GDP)	-8.2	-8.6	-4.3	-11	-17.4
Fixed capital investment (% of GDP)	28.0	30.5	24.7	30.3	31.9
Nominal credit growth (%)	55.6	12.2	11.6	31.8	34.6
Fiscal balance (% of GDP)	0.5	-0.7	-3.5	1.4	2.8

year, inflation was stimulated by the new upward trend in oil prices. Food prices increased faster than expected also at the beginning of 2008. Since at the same time excise duties were raised, the inflation rate accelerated temporarily to 11–12%. In February, the growth rate of food prices decelerated almost to the usual level but the risk of the re-acceleration of price rise stemming from world market prices remained high.

In 2007, the real exchange rate of the Estonian kroon appreciated by nearly 3% on average. This was mainly facilitated by the stronger growth of consumer prices compared to that in the partner countries, which is why growth in the real exchange rate of the kroon accelerated to 4–5% in the second half-year.

Until autumn, inflation was boosted by robust income growth. New jobs were created almost throughout the year but at a slower pace compared to the previous year and considerably less in the last months of the year. The annual average employment rate increased approximately 1.5%. The unemployment rate also continued to decrease, falling to 4% at the end of the year. Average wage growth was stronger than a year ago, but showed signs of deceleration in the second half. Wage growth outpaced productivity growth in most economic sectors in 2007.[1]

GENERAL GOVERNMENT

The general government budget was in surplus for the sixth consecutive year. According to preliminary estimates, the consolidated budget surplus for 2007 was 2.8% of GDP. Even though it was higher than targeted in the state budget strategy, compared to earlier periods, the surplus decreased more than might have been expected on the basis of slower domestic demand growth. The surplus was no longer induced by extra tax revenue but the planned increases in reserves as well as the postponement of some major projects at the local government level.

As concerns the tax policy, the Government continued efforts to reduce labour taxes and raise consumption taxes. At the beginning of 2007, both the corporate and statutory personal income tax rate was lowered by 1 percentage point to 22%. Since the non-taxable income threshold remained unchanged, the lower VAT rate that had been imposed on district heating and stove heating sold to households was increased to the usual level of 18% and wage growth accelerated further in the first half-year, the general tax burden increased by 1.5 percentage points as a ratio of GDP. The tax burden is expected to remain relatively similar also in 2008 if along with income tax rate reduction, excise duties on alcohol, tobacco and motor fuel are increased and an excise duty is imposed on electricity. After increasing tobacco excise duties, which is planned for July, excise duty rates will reach the minimum level agreed upon in the European Union and the harmonisation of tax policy can be considered completed.

On the expenditure side, the most significant change in 2007 was the abandoning of discretionary one-off pension increases and the introduction of a formula for calculating pensions so as to link them more closely with average wage growth.

As the budget surplus increased, the general government debt decreased even more. By the end of the year, the government debt-to-GDP ratio fell below the level of 3.5%.

For 2008, the Government is targeting a surplus of 1.3% of GDP. Although this target is more ambitious than in several earlier years, it may not be sufficient to support the soft landing of the economy. Moreover, by the beginning of the year it became clear that the revenue forecast might have been too optimistic and the investment programme in strategy documents too ambitious in order to achieve the aforementioned target of budget balance. This, however, means that the planned expenditure should be curtailed.

[1] For more details on the labour market see Eesti Pank's *Labour Market Review*, No 1/2008.

II. INFLATION IN 2007

CONSUMER PRICES

Like in the past few years, consumer prices grew faster than expected also in 2007. The expected deceleration of economic growth delayed and the growth of both private consumption and wages turned out to be stronger than expected in the first half-year. Therefore, price growth continued to accelerate until autumn. Unfortunately, in October and November the sharp increase in food prices started to appear on the world market. At the end of the year, inflation was boosted also by the new upward trend in oil prices, and in these months, the cost of the consumer basket increased 9% on an annual basis. The average annual rise in the cost of the consumer basket was 6.6%; that is approximately 4.5 percentage points more than the euro area average (see Figure 1). Both foreign and domestic factors contributed to this performance. Among the latter, the tax policy also played a role, although this contributed only 0.6–0.7 percentage points to the rise in inflation.

The tax policy played a bigger role at the beginning of 2008 when the excise duties on motor fuel, electricity, alcohol and tobacco were raised, causing the inflation rate to accelerate by approximately 1 percentage point. This together with the continuing rise in world food prices increased the inflation rate temporarily to 11–12% and overshadowed the fact that, in terms of core inflation, the acceleration had ended a few months earlier.

EXTERNAL PRICE PRESSURES

At the beginning of 2007, previous forecasts and the expectations of market participants gave reason to expect that external price pressures will be smaller than before. Indeed, in the first half-year, the growth of consumer prices in leading industrial countries decelerated. In the euro area, for example, inflation indicators were consistent with the European Central Bank's inflation target, which cannot be said about the same period in 2006. This is why Eesti Pank's macroeconomic spring forecast associated the moderate growth rate of consumer prices in the second half-year with domestic factors, particularly with the tax policy.

However, the situation changed after midsummer and the euro area inflation began to accelerate, reaching an unusually high level of 3.1–3.6% at the beginning of 2008. Estonia's non-euro-area trading partners witnessed similar developments. The annual average rise in the cost of consumer basket in the main partner countries was at least one percentage point higher than a year ago.

The above changes in the consumer prices in Europe, however, did not influence Estonia's inflation

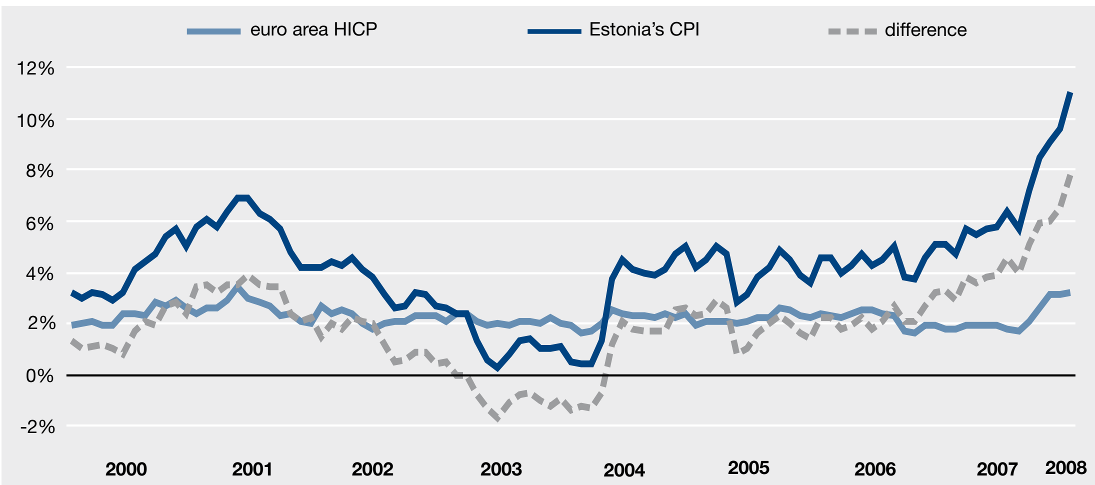

Figure 1. Annual consumer price growth in Estonia and the euro area

as much as the rise of commodity prices on the world market. The oil price that had been going up since the beginning of the year reached its historical high by the end of the year with 100 dollars per barrel and even exceeded that level several times in the first quarter of 2008. This price was much different from the levels recorded at the beginning and in the summer of 2007, and – based on the annual average figures – the oil price increased only 11–12%.

Inflation was also driven by growing prices of timber, metal and Russian-origin natural gas as well as the spillover effect of the oil price rise, which had began already earlier, on the prices of other energy carriers. In addition, there was a rise in world food prices in early autumn. Like in 2006, the underlying causes besides strong demand were considered to be the smaller than usual harvest resulting from poor weather conditions, the use of agricultural raw materials for the production of bio-fuel and lower stocks.

The impact of commodity prices on Estonia's inflation was amplified by the fact that despite rapid income convergence, the share of food products, for example, was still nearly 30% bigger and that of energy prices almost 20% bigger than in the old euro area countries.

Inflationary pressures, manifesting themselves through the prices of goods, were somewhat alleviated by the appreciation of the Estonian kroon. The exchange rate of the dollar decreased constantly throughout the year and the annual average cost of the kroon increased approximately 11%. Although the annual average indicators give reason to claim that the depreciation of the dollar offset the price growth of crude oil, the continuous appreciation of the kroon was of no help in the final months of the year and the initial months of 2008, when the oil price hike reached 30–70% in annual terms.

The exchange rate of the Estonian kroon has been fixed already for fifteen years – at first it was pegged to the German mark and later on to the euro. Currently, our main trading partners are the member states of the euro area and the EU. Naturally, the effective nominal exchange rate is now and then experiencing minor fluctuations via the euro, but not to such an extent as to offset external price shocks. For example, the average changes in the nominal exchange rate of the Estonian kroon, measured against all major trading partners, have remained between 0.5% and +3.6% in this decade. The average indicator of 2007 was 0.9%.

In addition to oil and oil products, the dollar is also used in the case of some commodity groups that are primarily purchased from Russia. This is why the constant depreciation of the dollar had a stabilising effect on the import price index in 2007. However, the dynamics of this index is determined by the prices of commodities and capital goods, and the index characterises mainly changes in the trade terms of Estonian companies and not changes in the prices of the consumer basket.

INCOMES AND DOMESTIC DEMAND

Domestic and external price pressures were stimulated by the strong growth of demand and incomes. The surge in private consumption was one of the reasons (although not the main one) for the exceptionally strong growth in the last couple of years. In the summer of 2007, the growth of private consumption began to slow. This together with the concurrent end of the construction boom brought about a considerable decrease in domestic demand.

Until autumn, domestic inflationary pressures were also supported by robust income growth. The creation of new jobs continued in 2007 but at a slowing pace. It came to an end only in the final months of the year. The annual average employment rate increased approximately 1.5%. Unemployment continued to decrease until the end of the year, falling to 4%.

Average wage growth was stronger than a year ago, but still showed signs of deceleration in the second half of 2007. Annual nominal wage growth increased 20% on average.

Wages increased faster than productivity in most of the economic sectors, particularly domestic-market oriented fields of activity, in 2007. Obviously, entrepreneurs became more active in passing on wage growth related cost increases to consumers through a price rise.

Additional increases in pensions kept pension growth comparable to previous levels, but it was still slightly slower than average nominal wage growth. Old-age pensions increased 17% on an annual basis.

In addition to the decelerating income growth, decreasing borrowing activity also contributed to the decrease in demand pressures. The growth of new housing loans slowed steadily, while the potential impact of the wealth effect on private consumption probably decreased too. Growth in the stock of consumer credit decelerated to 50% by the end of the year.

The summer of 2007 marked also a turn in household confidence. Economic expectations began to diminish at the end of the first half-year. Inflation expectations, however, did not change, although the accelerating price growth of food products became more perceivable because the media dedicated a lot of attention to the forthcoming price increases and tax changes. Households' inflation expectations started to decrease only at the beginning of 2008 after the implementation of the scheduled increases in consumption taxes.

FOOD AND ENERGY PRICES

Throughout this decade, the volatility of the world prices of motor fuel and food has been affecting the price developments of the consumer basket considerably in Estonia. Since 2001, the annual average price growth of food products has fluctuated by approximately 3 percentage points around the period's average. The prices of energy carriers, on the other hand, have been increasing throughout the decade. The extremely volatile oil price has been an exception to this trend. The related price decrease of motor fuel has temporarily (e.g. in 2002 and 2003) helped to keep consumer price inflation low.

In 2007, Estonia was among the three or four 3–4 EU countries with the highest inflation rates precisely because of growth in food and energy prices.

With regard to food products, price growth was the strongest in the case of dairy and cereal-based products. Although in the first months of 2008 the price growth decelerated, uncertainty about the future in relation to world market prices remained (see Figure 2). The first signs of robust growth in

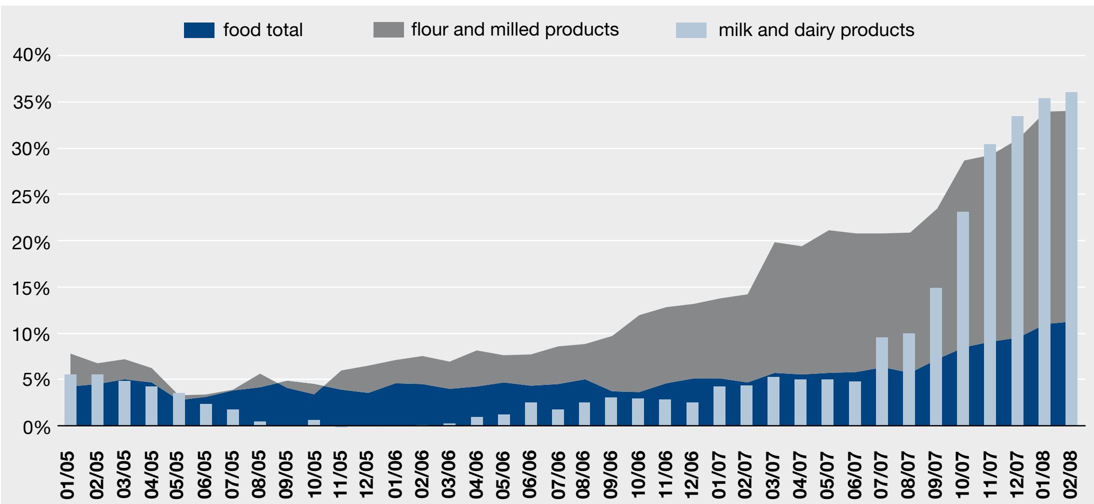

Figure 2. Rise in food prices in Estonia compared to the corresponding month of the previous year

food prices appeared in July and August 2007 when Estonian dairy companies increased their export volumes and raised the sales prices of their production. In the following months, the price increase was passed on to consumer prices (see Figure 3) when the prices of dairy products and butter grew 17% and 7.3%, respectively, compared to the previous month.

Production of milk did not increase in Estonian farms compared to the previous year. Higher world prices boosted exports; and thus, the exports of butter, cheese and milk powder increased 20–40%. Due to the shortage of raw materials, the prices of these dairy products increased the most on the domestic market.

The strong price growth on the world market had a significant impact also on flour and milled products. Owing to the global shortage of cereals, the price growth of bakery products has been somewhat faster than usual already since the summer of 2006. Estonia's output of cereals has been increasing constantly over recent years. The harvest of 2007 was even better than expected, being approximately 40% bigger than a year ago. However, this did not reduce the price pressures, as the exports of cereals also increased to the same extent.

Another key driver of energy price growth in 2007 was the new upward trend in oil prices and the price convergence of Russian-origin natural gas (which had been cheap so far) towards the average price level in Europe in the final months of the year. In addition, the whole year was characterised by the pass-through of earlier oil price rises to the prices of other energy carriers. The price of domestic gas increased on average 25% over the year and the prices of stove and district heating grew 24% and 17%, respectively. Growth in the price of stove heating was also supported by the construction boom related demand that continued to increase also in the first half-year. The price of electricity remained unchanged until January 2008 when the new excise duty, imposed due to the future opening of the market, added roughly 5% to the price.

The price of domestic thermal energy was considerably affected also by the raising of the value added tax imposed on thermal energy and domestic stove heating. More precisely, the value added tax

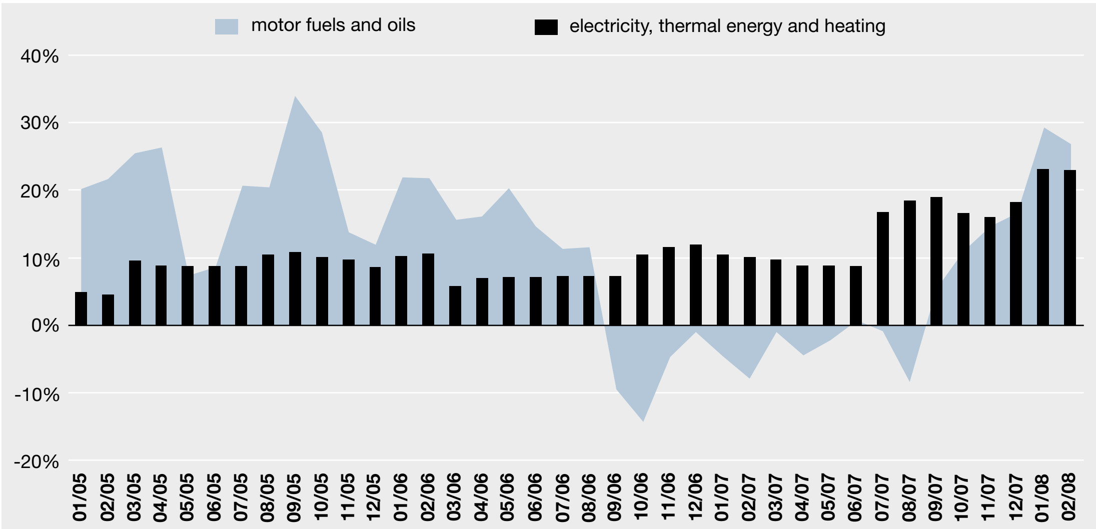

Figure 3. Rise in energy prices in Estonia compared to the corresponding month of the previous year

that had so far been lowered to 5% was now raised to the regular 18%. Without this rise, the price of heating would have increased a few per cent.

Growth in both food and energy prices was weaker in the first half-year. It accelerated only towards the end of the year when first signs of an overall easing in domestic price pressures began to emerge.

CORE INFLATION AND SERVICE PRICES

Labour market related price pressures should presumably diminish with the help of economic adjustment. In the second half of 2007, the decelerating wage growth already started to slightly affect the dynamics of core inflation. At first, it manifested itself in the end of the acceleration of price growth (see Figure 4).

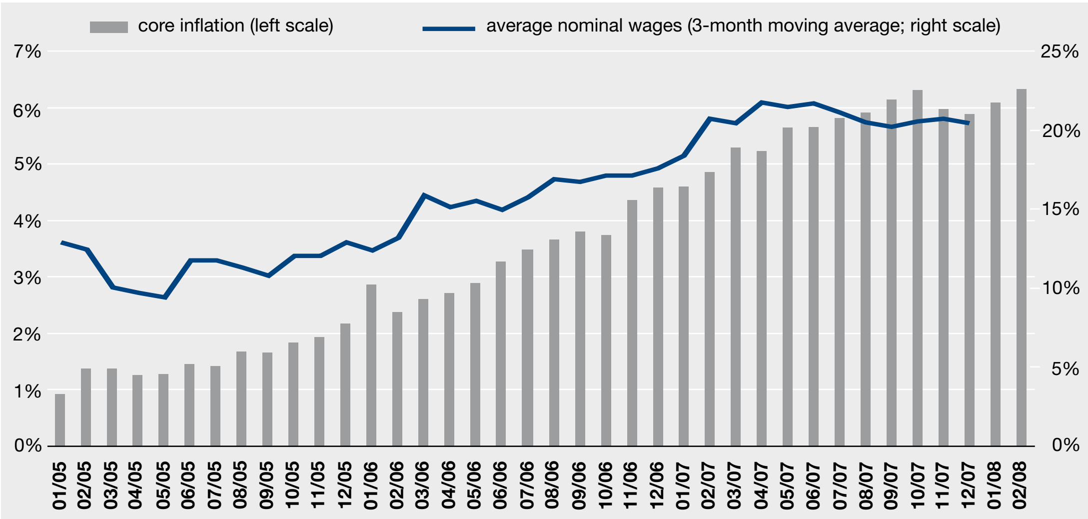

Figure 4. Changes in core inflation and average wages compared to the corresponding month of the previous year

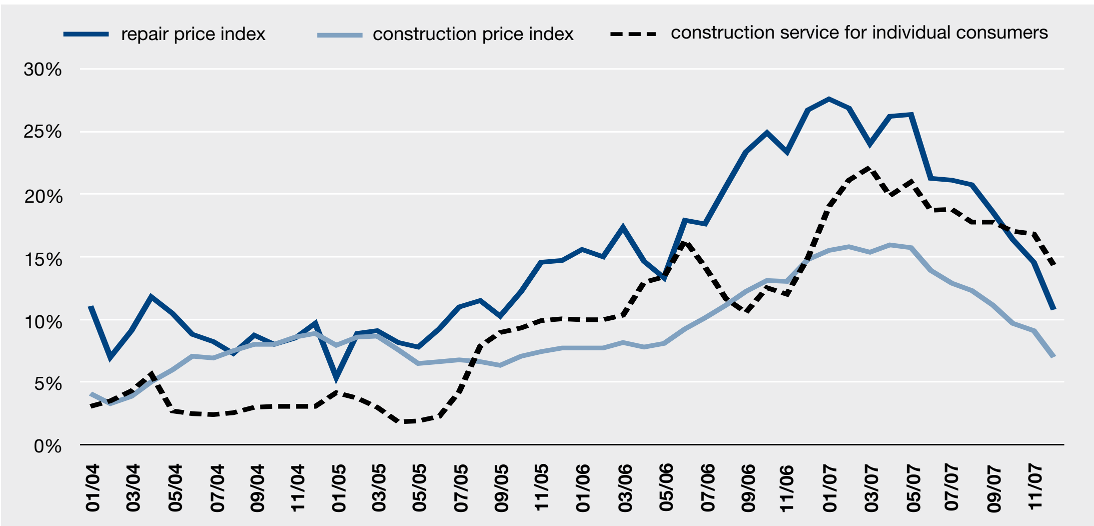

Figure 5. Rise in the prices of construction and repair works in Estonia compared to the corresponding month of the previous year

The impact of business cycle related factors on core inflation, which serves as the indicator of domestic price pressures, first appeared distinctly only in the fields related to construction. The acceleration of growth in the prices of construction and repair services sold to both companies and households peaked in the first months of 2007 and has been easing ever since (see Figure 5). The rents of housing also ceased to grow in the second half-year and began to decrease at the end of the year.

As regards other services, strong wage pressures could still be sensed at the turn of the year. Communication services were an exception here, with prices falling also in 2007.

In retrospect, it is clear that core inflation has been slightly supported also by price increases in some goods groups (e.g. clothes). As expected, the share of core inflation in consumer basket has increased along with wealth, reaching nearly 58% at the beginning of 2008. Only a third of the price increases over the last 5–6 years can be attributed to services. The rest stem from higher expenditure on durables, primarily cars and household appliances, which, in turn, has been stimulated by buoyant residential construction (see Table 1).

However, the relatively strong growth in the prices of semi-durable goods over the last three years is not logical. Semi-durable goods comprise mainly clothes and footwear that are import goods from Estonia's perspective. The fixed exchanged rate of the kroon and the depreciation of the dollar in the last couple of years should ensure that the prices of these goods rise or fall as much as abroad. Interestingly enough, this has not been the case after Estonia's accession to the European Union. In 2003–2004, the difference between the price changes of these products was almost non-existent. Ever since then, the gap has been widening. In 2007, the prices of these goods increased nearly 4.5% on average in Estonia; that is, by 3 percentage points faster than in old euro area countries. This seemingly inexplicable phenomenon worked against the reduction of inflation in 2007 – and again, in the final months. Based on the above, suspicion arises that the changes in the structure and quality of goods have been regarded as price growth.

However, despite the doubts raised above, the prices of import goods can still be classified under the factors that stabilise core inflation. It is much more difficult to answer the question which is the "right" growth rate for service prices in such a rapidly developing open economy as Estonia. Inflation indicators do not provide a clear answer to that question; to get the answer, growth in service prices has to be compared with the increase in the productivity of the exporting sector.

REAL EFFECTIVE EXCHANGE RATE OF THE KROON

As mentioned above, the Estonian kroon appreciated moderately throughout 2007. Driven mainly by the depreciation of the dollar, the nominal effective exchange rate of the kroon increased 0.9% on av-

Table 1. Contribution of core inflation to the consumer basket (%)

	2002	2004	2008	Change 2002–2008 (pp)
Total core inflation	50.3	52.8	57.6	7.4
Goods	25.5	27.1	30.3	4.8
durable goods	5.5	7.6	9.7	4.2
semi-durable goods	10.6	9.8	11.3	0.7
Services	24.8	25.8	27.4	2.6

Source: Eurostat

erage over the year. On an annual basis, the exchange rate of the kroon appreciated also against the Russian rouble. In the final months of the year and at the beginning of 2008, the growth rate of the nominal effective exchange rate accelerated to 2%.

Typical of the pegged exchange rate regime, the increase in the real effective exchange rate was largely caused by the faster growth in consumer prices compared to partner countries, being outpaced only in Latvia and Russia. In the second half of 2007, growth in the kroon real exchange rate accelerated to 4–5%, and to 6% in the first months of 2008. The average of 2007 remained slightly below 3%.

With regard to the competitiveness of the exporting sector, the appreciation of the real effective exchange rate was a clear indication of risk. However, typical of a small economy, Estonia is a price-taker. Therefore, the appreciating real effective exchange rate of the kroon is not the driver of growth in export prices, but it rather shows the possibility to sell Estonian products on the world market at a higher price than before. This, in turn, creates preconditions for income growth and thereby also for price increases in the non-tradable sector. The appreciation of the real effective exchange rate can, but need not necessarily, translate into a decrease in competitiveness. Imbalances arise only when domestic price growth of goods and services is not in line with productivity growth in the export sector.

Indeed, in 2007 the case was that the appreciation of the real effective exchange rate referred to stronger price growth compared to growth in productivity. Unit labour costs (measured in constant prices) did not decline over the year but increased instead for the second year in row. In other words, wages grew at the expense of profits, meaning that competitiveness decreased (other conditions being equal). Towards the end of the year, growth in unit labour costs did decelerate, but not enough.[1]

[1] For more details on unit labour costs see Eesti Pank's *Labour Market Review*, 1/2008.

III. ECONOMIC FORECAST FOR 2008–2010

Estonia's economic growth has been mostly in line with the autumn expectations; however, the growth has decelerated faster than foreseen in the autumn forecast base scenario. This has been caused by the higher-than-expected uncertainty in the real estate sector, slower increase in the external demand and the price hikes of food and other raw materials in the world market.

Compared to the time the autumn forecast was prepared, the external environment is currently much less favourable for the Estonian economy (see Figure 1). The past half-year has been characterised primarily by events in financial markets, where liquidity and credit problems have led to risk-related fears among investors. The economic activity indicators have been following a downward trend in many countries (including Estonia's main trading partners). Therefore, this year, the support from external demand to the Estonian economy will be weaker than forecasted in autumn and will not completely recover to its historical average by 2010 either. The slowdown in external demand is partly reflecting the difficulties in the US and European financial sectors that are gradually transmitting to the real economy. Similar to Estonia, economic growth in other Baltic States is expected to slow in the next few years and this will further reduce our growth potential.

The period from the second quarter of 2005 to the first quarter of 2007 will be remembered in the history of the Estonian economy as a period of exceptionally steady growth. The robust growth of recent years has exhausted several sources that have been supporting growth. On the supply side, there is much less unoccupied labour force available; however, the credit-driven domestic demand reserve has also decreased considerably. Consequently, growth can be boosted only through increased productivity, especially in the exporting sector.

The real estate sector is showing signs of cooling, which is one of the primary reasons why the investment growth figure has been substantially curbed in the current forecast. In this economic sector, buyers' confidence is low and, therefore, corrections are still under way.

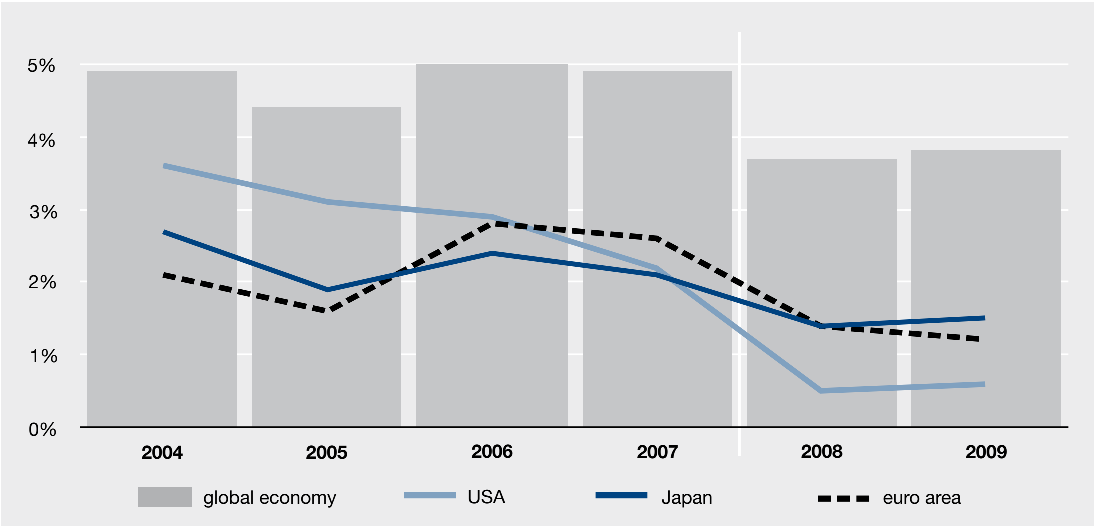

Figure 1. Global economic growth forecast

Source: IMF (April 2008)

Labour market flexibility will be the key factor determining the success of economic adjustment. The prolonged discrepancies between wage and productivity growth will continue this year as well. Similar to the autumn forecast, we also now expect a decline in employment, an increase in unemployment, and moderation of wage growth in 2008.

The rapid wage growth brought about a rise in prices in 2007 and probably also increased inflation inertia. The key concepts characterising inflation in Estonia in the next few years are a decline in domestic demand pressures, planned tax increases, volatile prices of food products and other raw materials in the world market as well as a rise in energy prices. All in all, due to the above factors, the inflation rate of 2008 will remain high for a while and will then slow in the next few years closer to the long-term average.

The external balance will continue to improve during the entire forecast horizon due to cyclical factors. We expect the current account deficit to decrease already this year as well as in the coming years. As a result of the slowdown in economic growth, external debt growth will inhibit and reach the level of nominal GDP growth in 2008–2010.

The three risk scenarios of the current forecast underline the possible development paths set out in earlier forecasts:

- stronger correction in domestic demand owing to the excessive credit expansion in the preceding years;
- materialisation of the wage and price spiral;
- faster improvement of the external environment and partial reallocation of domestic demand oriented capacities to exports.

Although there is no separate risk scenario for a less favourable external environment, we do not rule out the materialisation of this possibility.

FORECAST BASE SCENARIO

Economic growth

In 2007, economic growth slowed to 7.1% and the rapid cool-down period in the Estonian economy will continue at the beginning of this year. The economic confidence indicator calculated by the Estonian Institute of Economic Research has decreased to the level below which it has fallen only in 1998–1999. Since the historical experience of the Estonian economy includes only the recession following the Russian crisis, it is difficult to foresee the depth and duration of the downward phase of the current business cycle.

When comparing the current period of economic downturn to the period ten years ago, the financial sector supports the rest of the economy more efficiently and the corporate sector has better access to credit. Nevertheless, the current period of economic decline is likely to be longer and deeper than in 1999. The main underlying reasons are the following.

- Economy is operating close to the natural rate of unemployment, which is likely to reduce price and wage flexibility. Currently there are only modest signs of a downward correction in employment – the decline in employment has not yet started to alleviate labour market tensions.
- In 2000, the growth of external demand was the strongest of all time (EU economies were growing rapidly); however, the global economy is now cooling and thus external demand will not provide similar support.
- Too moderate decline in wage growth might undermine the competitiveness of export-oriented companies, which will hinder the fast recovery of export growth.

While in autumn we assumed that the real estate and construction sector would reach its low in 2008, we have now extended the period of recession until 2009. According to the Estonian Institute of Economic Research, the order books of construction companies have remained relatively healthy for the time being; however, further outlooks are less encouraging. Higher economic activity supported by a more favourable external environment can be expected no sooner than at the end of 2009 or at the beginning of 2010 (see Figure 2). Therefore, the **economic growth forecast for 2008–2010 is 2%, 3% and 5% respectively** (see Table 1). Compared to the recent years' average, the economic growth of the coming years seems to be weak; however, this should be interpreted as an adjustment from the level of extremely strong growth caused by recent years' one-off factors to a more sustainable level.

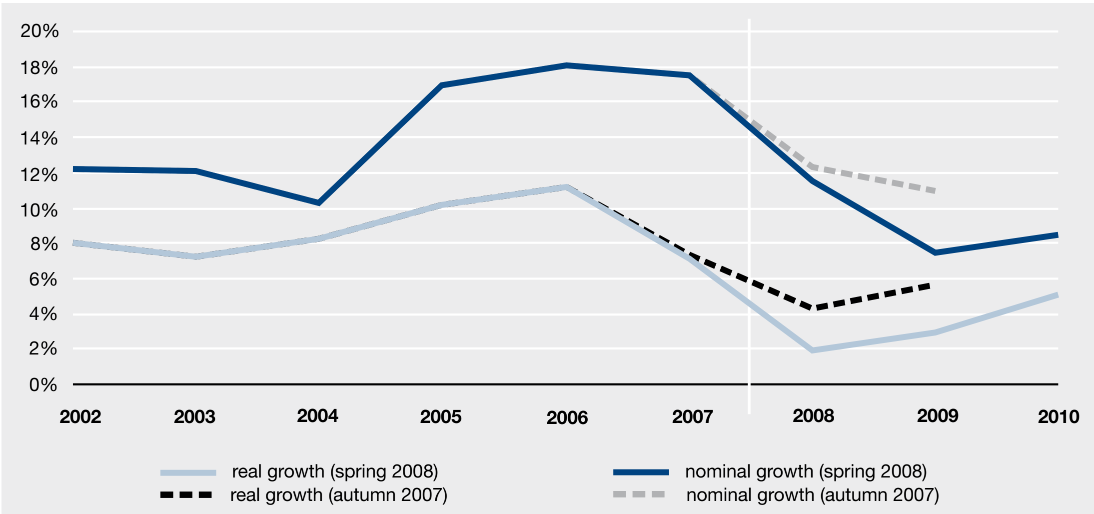

Figure 2. GDP growth forecast

Sources: Statistics Estonia, Eesti Pank

Domestic demand

The common feature in recent economic forecasts has been that the adjustment of domestic demand growth will be smooth and that current account deficit is not expected to decline rapidly once economic growth slows. Arising from the higher inflation rate and setbacks in the real estate market, the current forecast significantly reduces the domestic demand growth estimates for 2008. Over the recent years, domestic demand has been boosted by an expansive credit cycle, which is now coming to an end.

The real estate sector is the main source of corrections when it comes to investment growth. The share of investment in GDP will decrease to the levels recorded prior to the real estate boom but will still remain higher compared to more developed economies. Real private consumption growth will also remain more modest than expected in autumn, because the stronger-than-expected price growth will reduce households' purchasing power. Moreover, compared to last autumn, people have become somewhat more pessimistic, which is partly caused by the negative signals from the labour market.

Private consumption

This year, private consumption growth is going to decelerate quite sharply: from 8.9% last year to only 2.8%. If all negative circumstances (stronger price growth, faster slowdown in wage growth, and a steeper decrease in employment) coincide, private consumption growth might well be lower than GDP growth. In the next years, when confidence is gained in the new growth cycle, private consumption growth will also pick up speed (see Figure 3).

Table 1. Economic forecast by main indicators

							Difference from the autumn forecast		
	2005	2006	2007	2008	2009	2010	2007	2008	2009
GDP (EEK bn)	175.4	207.1	243.3	271.3	291.6	316.3	1.5	-0.2	-9.8
Real GDP growth (%)	10.2	11.2	7.1	2.0	3.0	5.0	-0.2	-2.4	-2.7
HICP growth (%)	4.1	4.4	6.8	9.8	4.5	3.0	0.5	2.4	-0.1
GDP deflator (%)	6.1	6.2	9.7	9.5	4.4	3.3	0.8	1.8	-0.7
Current account (% of GDP)	-10.0	-15.5	-17.4	-10.2	-7.5	-6.6	-2.3	1.7	2.1
Current account plus new capital account balance (% of GDP)	-9.3	-13.2	-15.8	-8.3	-6.1	-3.9	-2.9	1.6	1.7
Real private consumption growth (%)	10.6	15.1	8.9	2.8	3.8	4.5	-2.5	-3.6	-2.3
Real government consumption growth (%)	1.6	2.6	4.8	4.5	-0.3	1.6	0.7	2.4	-3.0
Real investment growth (%)	9.9	22.4	7.8	-9.8	-2.2	5.0	0.4	-8.2	-4.0
Real export growth (%)	20.5	8.3	1.5	2.2	4.8	6.5	-3.7	-3.1	-2.3
Real import growth (%)	16.3	17.1	2.8	-1.9	0.8	5.0	-2.2	-5.8	-4.5
Unemployment rate (%)	7.9	5.9	4.7	6.4	6.6	5.9	-0.5	0.7	0.4
Change in the number of the employed (%)	2.0	6.4	1.4	-2.4	-0.2	0.8	0.1	-2.2	-0.2
GDP growth per full-time employee (%)	8.2	5.3	6.7	3.1	3.2	4.5	0.6	-1.4	-2.7
Real wage growth (%)	8.5	11.9	13.8	5.7	2.7	3.5	-1.3	-3.1	-2.4
Average gross wage growth (%)	11.4	16.2	20.4	15.0	7.0	7.0	0.1	-0.0	-2.7
Nominal money supply growth (%)	42.0	28.2	13.4	11.6	8.5	8.9	-11.0	-3.4	-3.1
Nominal credit growth (%)	50.4	51.6	30.2	9.3	8.5	8.2	1.7	-6.3	-3.5
External debt (% of GDP)	85.3	96.4	110.3	110.1	110.3	110.0	2.8	1.2	1.9
Budget balance (% of GDP)	1.8	3.4	2.8	-1.2	0.0	0.0	-0.0	-2.3	-0.7

Sources: Statistics Estonia, Eurostat, Eesti Pank

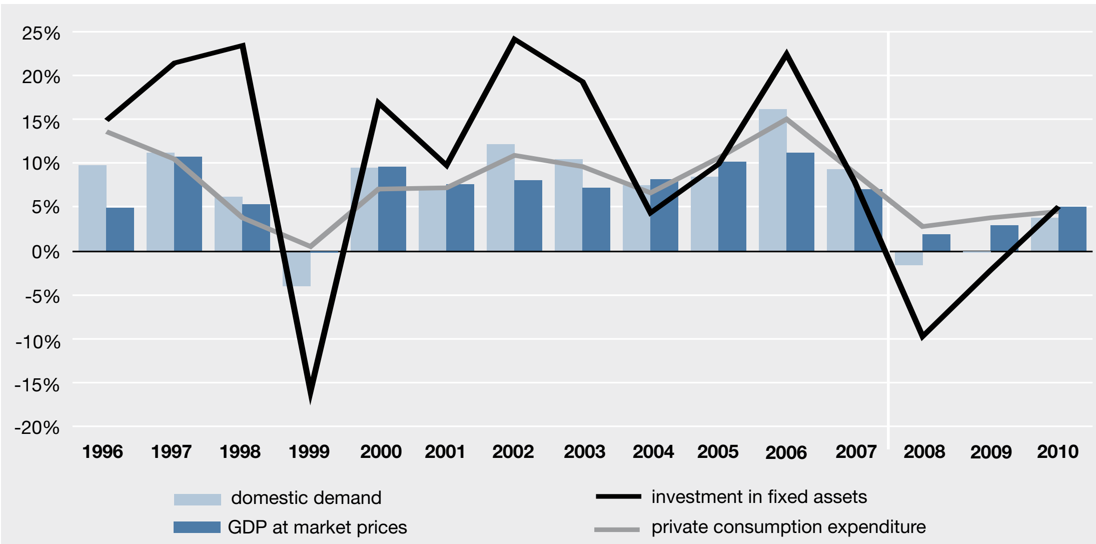

Figure 3. Real growth of domestic demand

Sources: Statistics Estonia, Eesti Pank

In 2008, the basic expenditure components – food, housing and transportation – which constitute nearly a half of total consumption expenditure and are difficult to give up – will undergo the highest price hike. Thus, expenditure on other goods and services (durables, recreational services) is far more likely to be curbed. Households whose consumption basket largely consists of basic commodities will suffer the most. The increased loan burden has raised consumers' sensitivity to changes in interest rates. So far, the possible negative impact of the heavy loan burden has not revealed itself that strongly in the context of low interest rates and fortunately, market participants are not anticipating a further interest rate increases in the near future.

Investment

In the next years, economic growth will be largely shaped by the investment growth cycle. Investments together with finished goods inventory react to the slowing economic growth faster than the rest of the domestic demand components. According to the spring forecast, investment activity will decrease further at the beginning of 2008 and will start increasing again in 2009–2010.

The keyword of further investment developments is adjustment in the real estate sector, which will greatly affect also the growth of the economy as a whole. In 2005–2006, the improvement of credit availability temporarily increased demand in the real estate market, which resulted in a price hike. The same reaction can now be seen on the supply side – there is an oversupply which has brought about a decline in prices. Companies that are better capitalised and have diversified their activities will survive the price corrections and the difficult times; however, the number of small enterprises going bankrupt will increase. Consequently, the economic growth potential will decrease as well.

Investment in production capital has not been that sensitive to the economic cycle compared to real estate investment, which allows, in their case, to expect smaller corrections. Further value added growth should be based more on productivity growth, which is why it is necessary to continue investments in production capital (including with the help of EU funds). According to the forecast base scenario, general government investment will partly offset the volatile growth of private sector investment. We will probably not witness a new household investment growth cycle before 2009–2010 and this will be more modest than seen in the recent past.

Labour market

In the spring forecast we still expect a decline in employment, an increase in unemployment, and wage growth moderation, but the projected changes are somewhat sharper than expected in the autumn forecast (see also Figure 4). Unemployment and wage growth have reached levels that will not be sustainable over the next few years. At the beginning of this year, employment growth adjusted slightly due to lower economic activity, but the same cannot be said about wage growth.

Wages and labour costs

The relatively rapid nominal wage growth in the near future will be driven, among other things, by an increase in minimum monthly wages and public sector wage fund as well as higher-than-expected inflation in the first half-year. Real wage growth will be 5.7% this year and is expected to slow further next year. The lack of available unoccupied labour force and high wage expectations are the main reasons forcing entrepreneurs to focus on enhancing productivity and developing more capital-intensive production.

Employment and unemployment

Inevitably, the turn of the business cycle will be reflected in the labour market statistics with some delay. If entrepreneurs perceive economic difficulties as temporary, they prefer part-time work to redundancies, and thus the correction in the number of working hours is a rather natural reaction. Employment will decrease the most in construction-related fields. According to the base scenario of the spring forecast, employment will decrease by

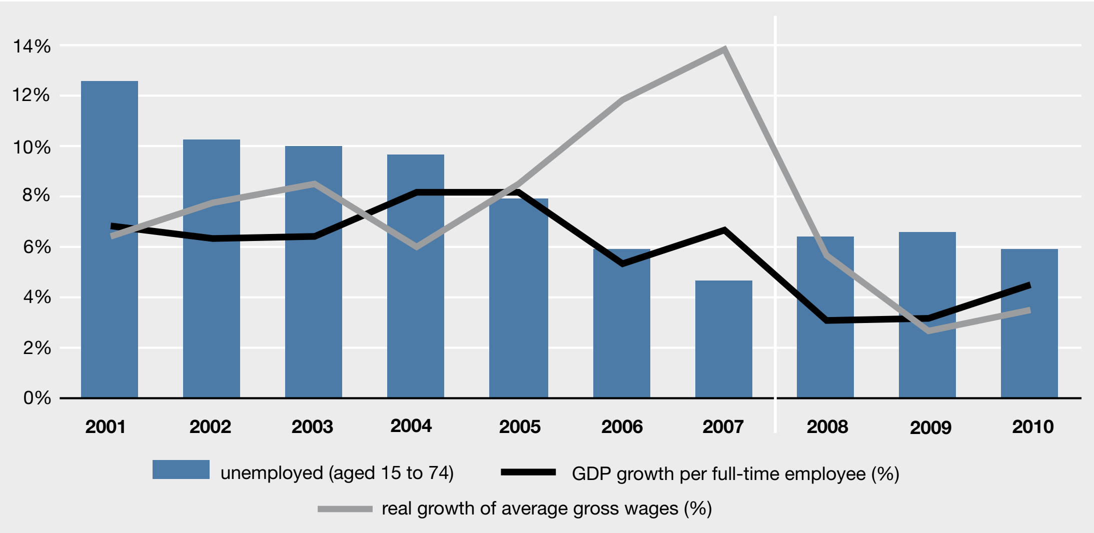

Figure 4. Employment development and wage growth

Sources: Statistics Estonia, Eurostat, Eesti Pank

about 15,000 this year, while the number of short-time unemployed is likely to grow the most. The unemployment rate expected for this year and the next is approximately 6.5%.

External balance and external debt

The external balance will continue to improve over the forecast horizon owing to cyclical factors. Last year's slowdown in private consumption and investment growth will continue also in 2008. Since the cooling real estate sector has a strong impact on domestic demand, the growth of imports will slow faster than expected in autumn.

The growth prospects of exports will weaken due to smaller import demand of Estonia's main trading partners and probably also because of strong cost pressures. The slowdown in export and import growth has also been boosted by decreased transit trade[1]. Weaker import growth has also entailed a considerable decline in current account deficit. Another factor contributing to the decline is the decrease in income account deficit. Although in the past year, the current transfers account decreased to 0.2% of GDP, in the next years, current transfers are expected to grow, primarily owing to the EU funds available for the new financial perspective and the use of previous period's funds. This year, current account deficit is expected to decline to 10.2% and in the following years, the balance will improve even more.

External debt growth will decelerate to a level comparable to nominal GDP growth. After the real estate boom, the private sector loan demand will decline and banks will be needing less external funds. So far, external debt growth has been driven by the increase in credit institutions' external liabilities and companies' intra-group direct investment in order to cover the need for corporate and household sector financing.

Inflation

In 2007, inflation continued to speed up, primarily because of strong domestic demand, administrative factors and external inflationary pressures. Al-

[1] Includes goods that are imported for processing and then re-exported.

though year-on-year price growth will accelerate this year, inflation is on the verge of a downward trend and thus a gradual decline in the upward pressures will be seen soon.

Compared to the autumn forecast, we have now increased the inflation estimate, mainly because of external factors. Owing to the extremely strong global economic growth of recent years, both energy and food prices will increase in the coming years. In the domestic economy, the inflation arising from rapid wage growth is declining this year, but the harmonisation of tax rates towards the EU level will continue feeding the inflation.

According to the forecast base scenario, Estonia's inflation rate will increase to 9.8% this year and decrease to 4.5% in 2009 and 3% in 2010 (see Figure 5). In 2010, price growth will slow to the long-term average level or even below that, bringing Estonia much closer to meeting the Maastricht inflation criterion.

Administrative factors

The inflation of 2008 will be raised by several excise tax increases that will account for up to 3 percentage points. This will make inflation growth very volatile. The new excise duties on motor fuel, alcohol, tobacco and energy took effect in January; an additional rise in the alcohol and tobacco excise duties will follow in the second half-year. The biggest effect of administrative price increases will emerge in the final months of 2008 and continue also in 2009. Currently, there is little information on the changes in tax rates in 2010. Pollution charges and fees for the special use permits of mineral resources will certainly continue to increase, which will influence also the prices of water and refuse collection. However, the contribution of this increase to inflation growth will be smaller than that of the factors stepping in 2008.

Main goods and services

The rise in food prices in the final months of 2007 in Estonia was rapid and broad based. In the fourth quarter of 2007, the prices of dairy products, cereals and meat grew 30%, 20% and 10%, respectively, year-on-year. The autumn forecast did not expect the price growth to be that robust. Estonia was affected by the strong price pressures from external markets, caused by the rapid growth of demand and the poor weather conditions of 2006

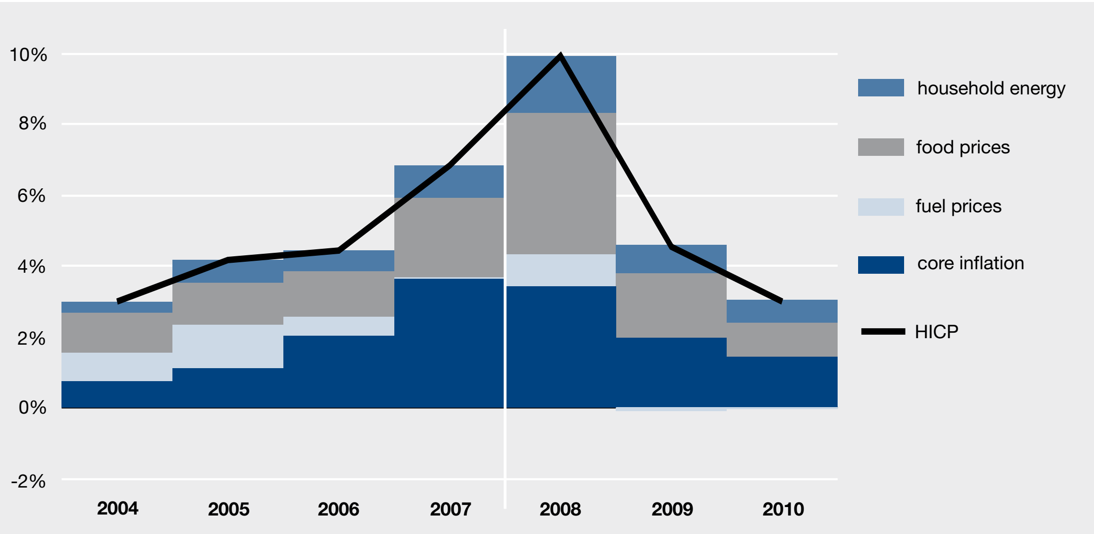

Figure 5. Inflation structure

Sources: Statistics Estonia, Eurostat, Eesti Pank and 2007 that were unfavourable for agriculture in the whole world. Due to the adverse weather conditions the crop was smaller than usual and demand-side pressures were stronger than expected.

The spring forecast relies on the assumption that the rise in food prices in the world market will stop in the second half of 2008. Moderation in the rise of food prices is also favoured by the slower global growth. In the second half of the forecast horizon, the increases in food prices depend, among other things, on income growth and changes in consumption preferences in less advanced economies, but also on energy prices.

Based on the above, we can assume that the peak of food price increases in Estonia was reached in October 2007. In the coming months, price growth will exceed the average level in the case of unprocessed foods: imported fruit and also domestic meat products. According to the forecast, the robust price growth of processed foods will come to an end in summer.

The prices of imported durables will continue to fall this year, favoured by the declining dollar exchange rate. The impact of changes in the dollar exchange rate will manifest itself in Estonia's consumer prices with a lag of up to a year. As competition in the retail market is tightening, there is room for noticeable price falls. The trade margin of retail sales has currently reached a record level. For example, the price level of clothes and footwear in Estonia already exceeds the EU average.

Motor fuel and energy

Inflation is strongly influenced by oil price changes. In February, the price of oil rose to over a hundred dollars per barrel in the global market. Given also the excise duty increase of January, the year-on-year average price growth of motor fuel is expected to be 21% this year in Estonia. Based on the first quarter's futures prices, markets expect the price of oil to fall to 94 dollars per barrel by end-2009.

The Estonian Competition Authority has approved the requests of several manufacturers to increase thermal energy prices by 10–15% in April 2008. The pressures for raising energy prices will strengthen throughout the forecast horizon, caused by the growing share of renewable energy, the opening of markets, the smaller number of pollution quotas and growing investment needs. From 2008 to 2010, we expect the price of electricity to increase 5% a year, but the rise might also well be higher.

General government

Based on the base scenario of the spring forecast, the consolidated budget of the Estonian general government will be in a deficit of 1.2% this year and balanced in the next two years. To achieve the balance, expenditure should be cut by 8 billion kroons in 2009 and 11 billion kroons in 2010 compared to the state budget strategy.

Although the structural balance of the budget will worsen in the following years, it will presumably not affect the real indicators of the economy considerably. This is due to the great degree of openness of the economy, which mitigates the impact of budgetary balance on domestic demand.

The tax burden will diminish slightly in the coming years and up to 1.3% of GDP in 2010. This is caused by the income tax reform and by domestic demand that will grow slower than in the past couple of years. No major changes (except for the corporate income tax) are expected in the tax framework in the coming years. Therefore, the tax environment will neither promote nor suppress economic developments (provided that the rise in excise duties has only a one-off effect on the consumer price index).

Banking sector

The accelerating domestic demand growth in recent years can be largely explained by strong credit growth. However, the time of strong credit growth is coming to an end. From the point of view of stable economic development, it is important that the support of the banking sector should enable the domestic demand to smoothly enter a new growth phase and that this support is strong enough to stimulate a new growth cycle.

Despite the cyclical recession, the Estonian economy continues to provide favourable investment opportunities in the medium term and it is inevitable that economic development must be financed, among other sources, with the help of foreign savings. A part of the (loan) resources necessary to finance the economy comes from the banking sector and therefore it is vital that the parent banks of Estonia's commercial banks have access to necessary resources. The base scenario of the spring forecast relies on the assumption that raising funds will not pose any difficulties.

Housing credit

Changes in the volume of new housing loans depend directly on the level of interest rates and the direction taken by the housing market that has been cooling while waiting for greater confidence about the future. The stock of housing loans is influenced by the repayment of old loans on the one hand, and by the taking of new loans on the other hand. Based on the spring forecast, the growth of loan stock will remain between 9–10% in the coming years.

Currently, real estate market participants are characterised by the wait-and-see attitude, which has caused the transaction activity to reach the lowest point of recent years. The key question is whether and how much the price corrections of new development projects will affect the prices of old apartments. In our spring forecast we expect the gap between the price of a square metre in old and new apartments to narrow, but the impact of new apartments on the prices of old apartments will remain small. As regards interest rate levels, we do not foresee significant changes in our spring forecast.

Consumer credit

Lately, increased uncertainty can be observed among households in respect of taking consumer credit: borrowing decisions are more careful and loans are taken more cautiously. Furthermore, consumer credit growth is inhibited by slow economic growth, high inflation and a slightly higher unemployment rate. In 2008, the annual growth rate of consumer credit will decline to 21% and then below nominal economic growth (5–6%).

Corporate credit

The slower growth in corporate loans is also influenced mainly by the real estate market. Another important factor is the sustainability of the exporting sector in launching new projects and the overall flexibility of the corporate sector while shifting their focus away from the real estate sector. Based on the spring forecast, corporate credit growth will decline to 6% in 2008 but will then accelerate to 8–9% in the following years, remaining close to nominal economic growth figures. In the long term, the growth rate of corporate credit will be twice the rate of economic growth.

This year, the growth of corporate credit will be inhibited by the decreased volume of loans taken for real estate development (for speculative purposes). Arising from the overall economic background, credit growth in other sectors will also be more balanced.

Overdue loans

The share of overdue loans in banks' loan portfolio will increase in the coming years and may exceed the current level by several times in the next two years, remaining, however, comparable at the international level. The growing share of overdue loans will be mainly facilitated by the less favourable general economic environment and weaker credit growth. Despite this outlook, various stress tests have shown that Estonia's banking sector is strong enough to manage with loan losses.

RISK SCENARIOS

The current risk scenarios surrounding the base scenario call attention to the same aspects we have pointed out also in the earlier forecasts. All in all, the economic growth outlined in the base scenario may be slower over the next year and a half. What comes after depends to a great extent on the business cycle of the external environment. Inflation growth, on the other hand, may be stronger this year than suggested in the base scenario, although there is a possibility of a sharp decrease in the years to follow. The source of uncertainty in respect of the impact of different inflation factors is the reciprocal impact of external and domestic inflation.

Risk scenario 1: Correction in domestic demand

The ratio of the private sector loan stock to GDP has increased from 70% to 100% over the last two years. The economy has absorbed a considerable amount of credit. Although this has boosted economic growth, it has also increased price levels. The use of loan money is not problematic if it is used in a way that steadily increases the volume of economy. However, it cannot be ruled out that the increase is only temporary. The first risk scenario describes the situation where economic growth has been supported by a temporary component.

The temporary increase in the volume of economy is particularly illustrative in the real estate sector: when credit growth slows, part of the demand will disappear and the number of square metres built in a year will decrease considerably compared to the level before the slowdown. The current decrease in the real estate sector is being signalled by the rapid decline in the number of new housing projects. As regards commercial property, the strong growth has continued so far but this segment may witness a later slowdown. When an enterprise goes bankrupt, there will be unengaged workforce, some of whom might go abroad and some to other sectors. Readjustments can also be expected in other fields that were benefiting from the strong growth in the real estate sector, e.g. the building materials industry and commerce.

Risk scenario 2: Utilisation of export potential along with new global growth cycle in 2009

As regards the near-future developments of global economy, there is a lot of uncertainty at this point of time. Therefore, the forecast base scenario is based on the assumption that external demand growth will gradually start to recover in 2009. However, in a number of countries, economic policies put increasingly more focus on preventing economic decline and preparing for a new growth cycle. According to this risk scenario, the Estonian economy would grow faster than anticipated in the base scenario because the external environment would provide more support to productive capacity growth.

The slowdown in global economy might be temporary. In such case, the growth in oil and food prices is likely to continue and global price pressures will probably remain strong.

As a result of the extended domestic demand cycle, there will be production resources in Estonia that could be used to increase the export potential (e.g. in the case of the exports of goods and services related to construction). This will result in faster economic adjustment, which relies on the robust growth of export demand. This will continue to tighten the labour market and keep wage and price pressures high.

Risk scenario 3: Wage and price spiral

The rapid price increases have been fuelled by the robust wage growth that started in 2006. The inflation rate remains high also due to external factors (increase in energy and raw material prices) and administrative measures (changes in excise duties). There is a risk that if the price growth remains rapid for a while, economic agents will start to consider it

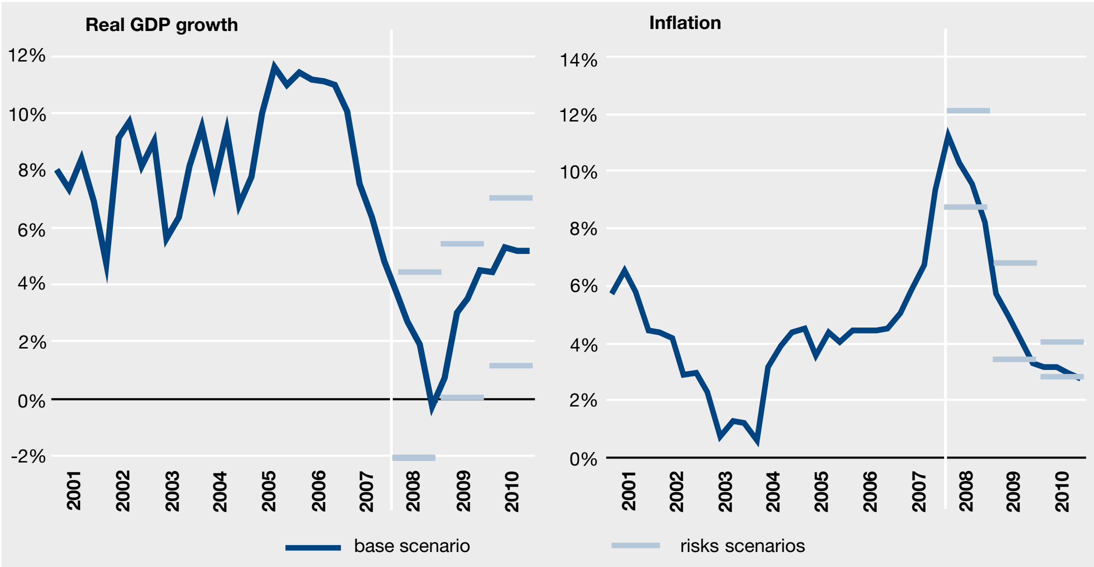

Figure 6. Risk scenarios for real GDP growth and inflation

Sources: Statistics Estonia, Eesti Pank

as something permanent. This, in turn, would affect price and wage formation (e.g. indexation) and also consumption and investment behaviour.

According to this scenario, Estonia's nominal convergence towards the EU average will accelerate, whereas real convergence will slow. Competitiveness problems in foreign markets keep export and GDP indicators low. High inflation cannot be sustainable over a longer period. Therefore, the wage-price spiral may end abruptly together with a longer-term correction in the real economy.