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ECONOMIC FORECAST FOR 2009–2011

CONCLUSION

This forecast is based on information available as at 2 April 2009 and will be published also in the central bank's publication Estonian Economy and Monetary Policy No 1/2009.

The cooling of Estonia's economy started already two years ago, led by the slowing domestic demand. In the second half of 2008 this was complemented by a sudden deterioration in the conditions of the external environment. The global financial crisis gradually started to affect Estonia's main trading partners, which brought along a rapid decline also in Estonia. Estonia's economy that had operated at full capacity only a couple of years ago is entering an environment where the level of capacity utilisation has substantially fallen. As a result of the rapid decline in demand, the increase in prices gives way to a decrease and labour is cheapening. Given the increasing uncertainty, expectations have become more pessimistic, which in turn escalates the downturn. For a small open economy like Estonia it is essential for future growth that the external conditions start to improve. According to present expectations, the situation might start to improve only at the end of the year, but more pessimistic scenarios cannot be excluded either. In addition, it is necessary that the post-shock restructuring be completed in large part and the imbalances recede. Based on the present forecast, growth will recover in 2011 but only provided that the euro will be introduced at the same time.

Estonia's economy is facing several external shocks. Similar to many other countries, Estonia's export revenues have decreased by more than a quarter owing to the strong decline in external demand. There are large uncertainties regarding the time and speed of recovery. The Estonian economy also has to cope with the decreasing confidence of foreign investors. This means a considerably smaller foreign capital

inflow compared to the previous levels. The adoption of the euro would help restore confidence as soon as Estonia joins the euro area.

In addition to external shocks, several unfavourable tendencies can be noticed in the domestic economy. The earlier credit boom, which boosted growth in previous years, has been replaced by tighter credit conditions. Banks and investors have become much more cautious. This is partly due to the concern about growing loan losses, which, owing to the strong capitalisation of banks, do not pose a risk to Estonia's financial stability though. Economic activity in the real estate sector has diminished significantly and prices have dropped considerably. As a result of decreasing demand, corporate income flows are significantly lower than expected in previous years. Therefore, the high debt burden must be brought into line with the new income flows. The falling prices complicate the servicing of the loan burden although the situation is somewhat mitigated by the decreasing interest rates. Nevertheless, it will be costly to maintain under-utilised production capacity for a longer period of time, which is why the supply side of the economy must adjust to the current demand structure. This implies that economy has moved into a period of urgent restructuring that will continue also next year. The sharp decline following the period of strong growth makes the present phase of the economic cycle rather costly in terms of resources.

The ability of the product and labour market to adjust to the rapidly changing economic situation will pose a major challenge for the Estonian economy. For many businesses the adjustment contains in a compromise between lay-offs and wage cuts. This is illustrated by the robust increase in unemployment at the beginning of 2009 that will continue at a slowing pace until next year. This year and the next test the flexi-

bility of wages in the background of rapidly falling demand. The growing number of the unemployed and fear of losing one's job will significantly weaken employees' bargaining power in wage negotiations. According to the forecast, average gross wages will decline to some extent both in 2009 and 2010. Wages should be lowered first and foremost in those sectors that contributed the most to the wage boom of previous years and caused imbalances between productivity and wage growth.

The price changes of recent months indicate that the economic downturn has made inflationary pressures non-existent. On one hand, this has been caused by the decline of global commodity prices, which will lower the prices of energy and food in Estonia this year. On the other hand, the price fall is affected by domestic factors. Companies still have large stocks that have to be disposed. Due to excessive production capacity, prices of production factors are dropping. Consumers are cautious, as there is large uncertainty about the future, incomes are diminishing and loans are not taken so easily any more. According to the forecast, the price level will continue falling until next year and Estonia will be able to meet the Maastricht inflation criterion already at the end of this year. The domestically driven inflation will regain momentum as soon as Estonia's economic growth starts to recover and income convergence towards the incomes of advanced European economies will continue.

For years, Estonia's economic growth has been accompanied by the current account deficit, which has resulted from large investment needs and consumption boom. This year will be an exception in this context because both the households and businesses will be spending substantially less because of the prevailing uncertainty. Budget constraints will also be tighter because of the decrease in incomes, and the cautious behaviour of banks and investors

restrains borrowing. The current account surplus will be temporary because the new growth cycle requires investment activity to pick up, and the foreign trade deficit will start to grow.

The economic performance of recent years made it possible for the general government to spend more and increase income transfers. The economy witnessed drastic changes at the end of last year, which is why the earlier expenditure plans need to be revised and brought into line with the changed income level. As Estonia has set out to adopt the euro, it is extremely important to keep the state budget deficit within the Maastricht budget criterion. To this end, this year's budget balance should be improved by an additional 8.5 billion kroons in addition to the supplementary budget adopted in February, and next year's budget by an additional 7 billion kroons. However, the fiscal measures taken after the February cuts have been modest compared to this objective.

One of the keywords in this spring forecast is the exceptionally large uncertainty in the global economy and thus also in the Estonian economy. In this context, the forecasts of different institutions diverge considerably. Thus, the base-line scenario of Eesti Pank's spring forecast is accompanied by two additional risk scenarios. The first one anticipates the recovery of the global economy quite soon, whereas the other expects the recession to continue also next year.

EXTERNAL ENVIRONMENT

Global economy is going through exceptional times because of the financial crisis. The crisis that started from the US financial sector has become much more expansive than expected, forcing market participants to revise their global as well as regional economic forecasts downward. The risk that global GDP will decline for the first time in 60 years is materialising. According

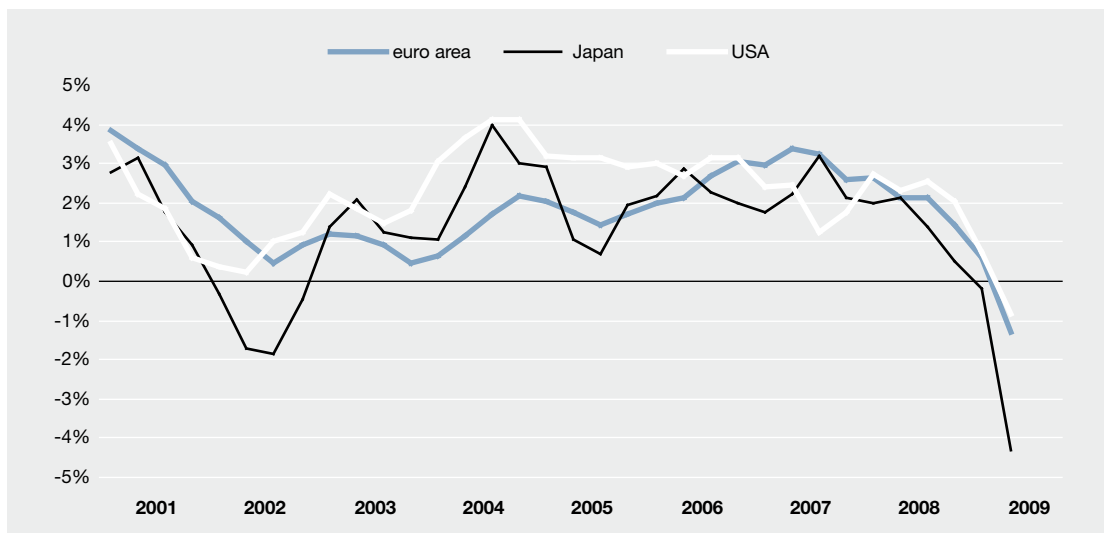


Figure 1. Annual GDP growth

Source: EcoWin

to international organisations, the decline could reach a couple of percentage points. Economic recession has reached the euro area, the United States as well as Japan (see Figure 1); China is one of the few countries that has managed to maintain an upward trend. The slowdown in economic activity and problems in the financial

sector have brought about the need to intervene extensively in the functioning of the financial market and real economy in most countries. Although governments and central banks have taken various stabilisation measures, there are no clear signs of improvement yet. At this point, it is hoped that the situation starts improving at the end of this year.

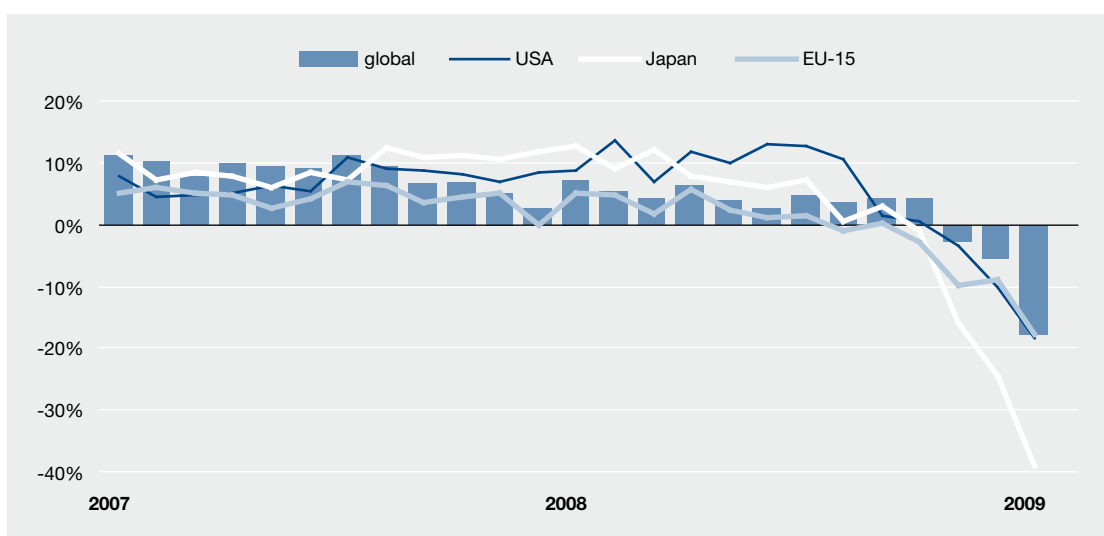


Figure 2. Export growth (y-o-y)

Source: CPB

Financial markets were yet considered to be the main transmission channel of the crisis in mid-2008, but in November the crisis hit also foreign trade. Both the financing of foreign trade and decreasing confidence played their part. Uncertainty about future income streams has strongly affected consumption behaviour. At the moment, it is still not clear why trade contracted sharply in November 2008 (see Figure 2). The decrease in domestic and external demand has brought about a rapid fall in industrial production volumes, reaching 17% in the euro area and 10% in the United States in January, year-on-year. The leading economic indicators do not indicate a break in the downward trend yet. In addition to the lowering consumer confidence also the deflation risk has increased. This could become the factor behind postponement of consumption. That, in turn, would deepen and prolong the recession. The efforts of countries to avoid protectionism are hindered by strong interest groups who prefer domestic businesses in national stabilisation measures. The positive impact of protectionist measures is definitely questionable in the short term and even less does it outweigh the negative outcomes in the longer term.

The central banks of major economies have made sizable cuts to interest rates in the face of economic turmoil. A growing number of countries have lowered the monetary policy interest rates below the historical minimums. In addition, central banks have actively provided liquidity in the money markets. In order to maintain confidence in the banking sector, the ceilings of the deposit guarantee scheme have been raised and cross-border cooperation in guaranteeing financial stability has been strengthened.

The stimulation of economy has its price. One of the drawbacks of extensive fiscal measures is the rising debt burden of governments. The price of current stimulation measures is the cuts in future government budgets or increases in

taxes. Long-standing low interest rates could endanger price and exchange rate stability after economic growth has recovered. In this case, the process of phasing out the incentives should be started immediately to avoid further negative developments. Yet another risk is that the key institutions (e.g. the labour market) of major economies are not flexible enough to guarantee a smooth transition of the global economy to a new growth phase.

Estonia is characterised by close financial and economical integration with Nordic countries, which means that the well-being of those export markets has a huge impact on the Estonian economy. The economic recession of our southern neighbours decreases our external demand as well as the credibility of the Baltic region in the eyes of foreign investors this year. In small open economies, besides the external environment, the speed of recovery of economic activity largely depends on economy's flexibility, fiscal discipline and access to foreign capital.

FORECAST BASELINE SCENARIO

Economic growth

The cyclical cooling of the Estonian economy started already in 2007 and turned into recession in the middle of 2008. Driven by the global financial crisis, the recession was complemented by large uncertainty and, at the end of the year, also higher than expected decrease in external demand. These factors accelerated the year-on-year decline in GDP to as much as 9.7% in the fourth quarter. Meanwhile, in the third quarter, GDP decreased 3.5% year-on-year. GDP for 2008 shrank 3.6% (see Figure 3).

At the beginning of 2008, the decline was apparent mainly in trade, transport, storage and communications, and electricity, gas and water supply. However, in the fourth quarter, the decline was much more broad-based and deeper in the

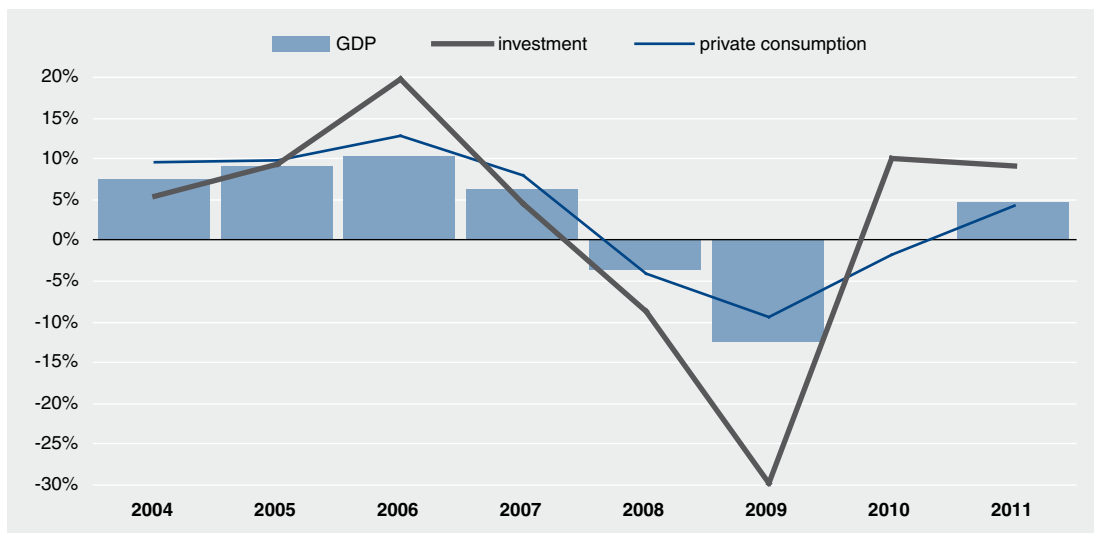


Figure 3. Real GDP growth (y-o-y)

Sources: Statistics Estonia, Eesti Pank

sectors that depend on the external environment. The only exceptions were public administration, social care and education, which experienced modest growth year-on-year.

The gradual cooling of the economy put an end to the period of credit-driven growth. Transition to a more sustainable growth level had become

necessary because of the imbalances that occurred in the economy in the years of robust growth (see Figure 4). With strong external demand, transition from one growth regime to another would have been easier for Estonia. The current global crisis amplifies the slowdown in economic activity and will result in a deeper correction in incomes.

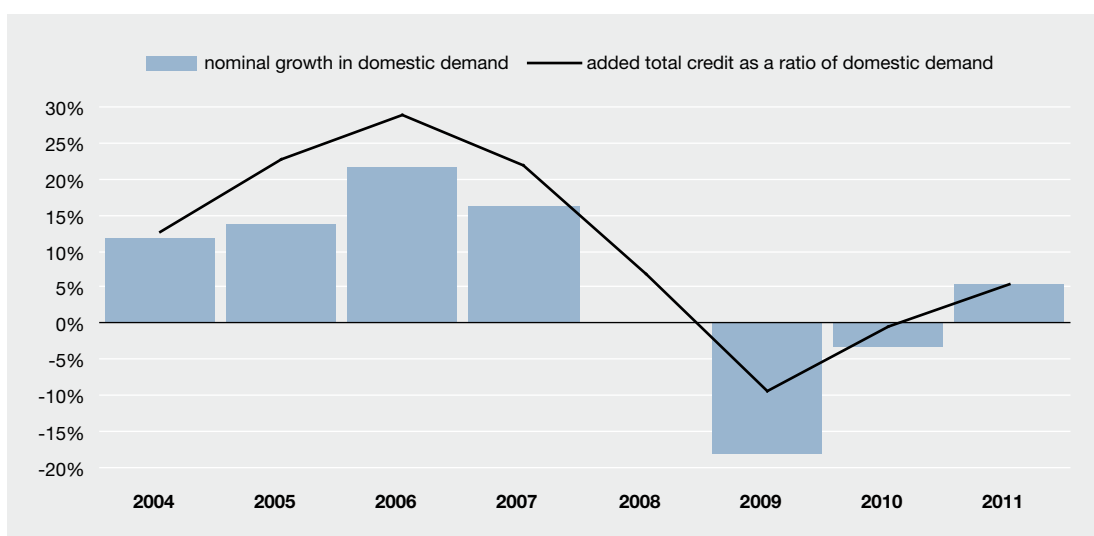


Figure 4. Domestic demand

Sources: Statistics Estonia, Eesti Pank

The majority of confidence indicators are currently very low, indicating weak demand, excessive production capacity and lack of confidence. Manufacturing companies intend to further reduce their workforce in the coming months, since there has been a drastic decline in orders whereas stocks are still large, which is why sales prices are on a downward trend. All this indicates that the economic contraction will continue or even deepen in the first half of this year.

GDP will decrease considerably this year as well, and if the external environment does not improve any time soon, the decrease will continue also next year. In 2009, economy will decline 12.3%. Assuming that our main foreign trade partners will see the crisis recede by the end of this year and extensive support packages will bring these countries out of low by 2011, Estonia's economic situation will improve next year and a new growth cycle might gain momentum in 2011. According to the forecast baseline scenario, larger economic imbalances will have receded by that time.

To start with the new upswing, economic restructuring should be more or less completed. First of all, the restructuring should help to restore productivity growth. This requires bringing the number of employees in line with the production output that would meet the demand. This process has started off already. Based on the spring forecast, growth in productivity will recover at the end of 2009 or at the beginning of 2010.

Along with the decreasing demand, a substantial amount of production resources has been left unutilised. The positive GDP gap of previous years has rapidly turned negative. According to the Estonian Institute of Economic Research, the utilisation of production capacity dropped to 58% at the beginning of this year; during the boom of 2006-2007 this indicator stood at 80%. This shows that should the earlier demand recover,

economy could take a major leap from the current level. Nevertheless, maintaining under-utilised capacity will become expensive in the long term, which is why the supply side of the economy must adjust to the new demand structure. This process is time-consuming and will extend also over to 2010. In sectors that increased their loan burden more in recent years, the transition processes can last even longer.

After the restructuring is complete, a significant share of the current capital stock will not be in use any more. The banking sector plays an important role in this context by providing credit support to the restructuring process. The course of adjustment is affected by banks' ability to distinguish between companies based on their success and take reasonable risks in financing new projects. Although banks are still willing to grant credit to promising projects, given their current level of capitalisation, their excessive risk aversion might pose difficulties also for companies with good prospects. In the coming years, however, banks' lending behaviour will be largely affected by the level of loan losses and its effect on the banks' capital buffers in Estonia as well as in parent banks' countries of origin. Insufficient capitalisation might force banks to start restricting lending exactly at the time when the economy needs strong support from the banking sector.

Under-utilisation exerts pressure on the prices of factor inputs. That is why both the labour and production capital are expected to cheapen this year and also the next. The fall in the prices of factor inputs also passes through to the prices of products; therefore, the GDP deflator indicates a decrease in Estonia's price level. For the same reason, also the prices of exported goods will slightly decline.

According to the spring forecast, the turning point in the economic cycle is expected this autumn, provided that the global economic downturn

will come to an end in the second half of 2009. Thus, Estonia will experience a significant drop in incomes this year, but next year this process will stabilise and 2011 will witness the beginning of a new growth period. The main risk factor of this estimate is the assumption that the external environment will stabilise in the second half of this year (see Table 1).

Domestic demand

Private consumption

The uncertainty surrounding the current economic situation and deterioration of the future outlook have considerably reduced consumer confidence in the past two years and consumers have become much more conservative.

In 2000-2007, consumption increased by an average of 9.5% a year, supported by wage

growth, optimistic expectations and large financial capital inflow into the Estonian economy. In 2007, consumption was as much as 2.8 times higher than in 1995. This remarkable increase was followed by a 4% decline in 2008. Besides the plummeting consumer confidence, the decline was supported by an increase in inflation that started in the second half of 2007, which reduced households' purchasing power. Moreover, also interest rates grew, which together with the rising loan burden significantly increased loan servicing costs.

Households responded to the higher uncertainty by starting to increase their savings from the first half of 2007. Compared to several other developing countries, the rate of household savings in Estonia has been constantly lower and, therefore, the increase in savings was a necessary step towards a more balanced development (see

Table 1. Economic forecast by key indicators

	2006	2007	2008	2009	2010	2011	<i>Difference from previous forecast</i>	
							2009	2010
GDP (EEK bn)	205.0	238.9	248.1	213.9	203.8	213.9	-36.9	-53.4
Real GDP growth (%)	10.4	6.3	-3.6	-12.3	0.2	4.7	-7.5	-1.3
HICP (%)	4.5	6.8	10.6	-0.5	-2.9	-0.8	-4.2	-4.9
GDP deflator (%)	7.0	9.6	7.9	-3.2	-3.4	1.9	-7.1	-4.4
Current account (% of GDP)	-16.7	-18.1	-9.2	2.7	-1.7	-4.9	8.9	5.4
Current account plus capital account balance (% of GDP)	-14.6	-16.9	-7.4	4.8	2.1	-1.3	9.3	5.9
Real private consumption growth (%)	12.8	7.8	-4.0	-9.5	-1.7	4.7	-5.1	-4.1
Real government consumption growth (%)	1.8	3.9	4.4	-9.0	-4.3	3.9	-4.8	-4.1
Real investment growth (%)	19.8	4.5	-8.6	-29.6	10.4	9.9	-12.8	9.4
Real export growth (%)	12.0	-0.3	-1.0	-27.6	14.8	18.2	-23.6	12.5
Real import growth (%)	20.7	4.0	-8.1	-34.3	18.5	19.4	-25.9	16.2
Unemployment rate (%)	5.9	4.7	5.5	12.8	13.7	12.5	3.5	3.0
Employment growth (%)	6.4	1.4	0.2	-5.2	-2.1	0.1	-0.5	-0.7
GDP growth per full-time employee (%)	4.5	5.8	-3.3	-10.6	4.3	5.8	-9.6	1.7
Real wage growth (%)	11.6	11.6	3.3	-4.7	-3.2	3.7	-2.2	-2.9
Average gross wage growth (%)	16.2	20.4	13.8	-5.2	-5.8	2.9	-6.7	-7.5
Nominal money supply growth (%)	28.2	13.4	3.5	-8.5	-2.2	3.6	-2.4	-2.7
Nominal credit growth (%)	51.6	30.2	7.3	-7.5	-0.5	4.9	-7.5	-2.4
External debt (% of GDP)	97.7	112.4	120.2	133.4	142.0	123.9	12.0	15.4
Budget balance (% of GDP)	3.3	2.7	-3.0	-2.9	-2.9	-2.6	0.5	-0.7

Sources: Statistics Estonia, Eurostat, Eesti Pank

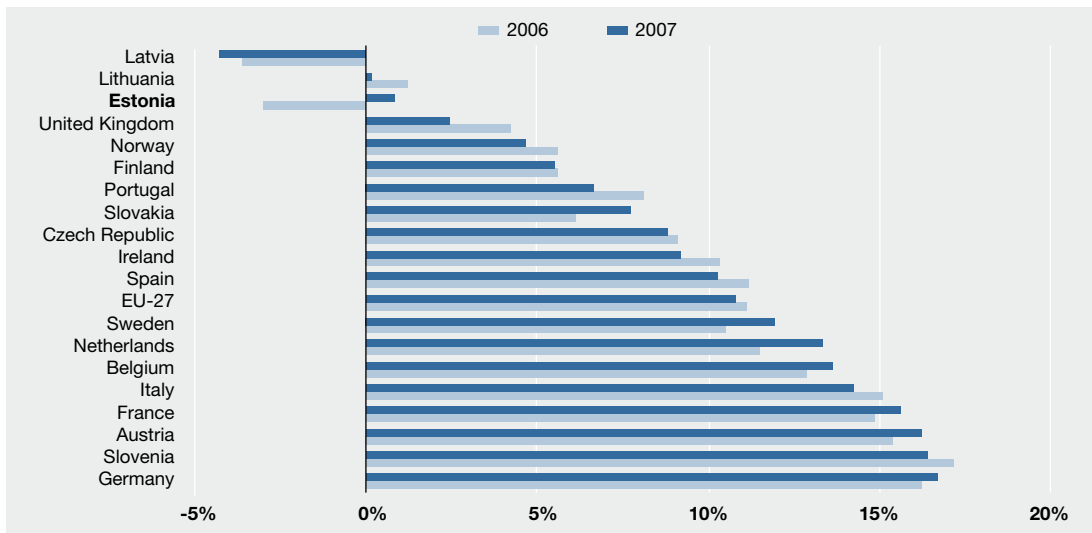


Figure 5. Gross savings as a ratio of disposable income

Source: Eurostat

Figure 5 on gross savings¹). On the other hand, it is natural that uncertainty makes people hold more reserves and liquid assets. In 2008, households were motivated to save more also because of higher deposit interest rates, which in 2009 are declining though.

In 2008, purchases were not so extensively financed by credit. Furthermore, at the end of the year, banks became more cautious in offering loan products intended for purchasing durable goods. This led to a more than 10% decline in the sales volume of retail trade in the fourth quarter of 2008; at the beginning of this year, the decline has deepened. At the end of the year, as regards the main components of the consumer basket, private consumption expenditure on clothing and footwear decreased most rapidly – nearly 22%. At a more detailed level, the acquisition of vehicles slumped altogether 46%. The consumption of goods related to real estate decreased sharply as well; for instance, the purchase of furnishings (furniture, carpets and other floor covering)

declined 35%. The lavish spending in previous years was fostered by a hike in real estate prices, which increased household liquidity and demand for durable goods related to real estate. This year, however, sees a very deep depression in this sector.

In 2009, private consumption will undergo a further correction following the rapid growth of previous years. So far, the correction has mostly been led by more cautious behaviour of households whereas in the future it will be led by income decline. On one hand, incomes will decrease as a result of job losses. On the other hand, wage income will decrease too. A growing number of people will have to use their savings in order to avoid a decrease in the living standard. Although from April 2009, a 5% rise in pensions will contribute to an increase in disposable income, it cannot offset the decrease in wage income. The second supplementary budget for 2009 is likely to reduce disposable income even further (see Figure 6).

¹ The gross saving rate of households describes the part of disposable income that is not used for final consumption. Gross saving is calculated by dividing it by disposable gross income, which has been adjusted with changes in the net assets of pension fund reserves.

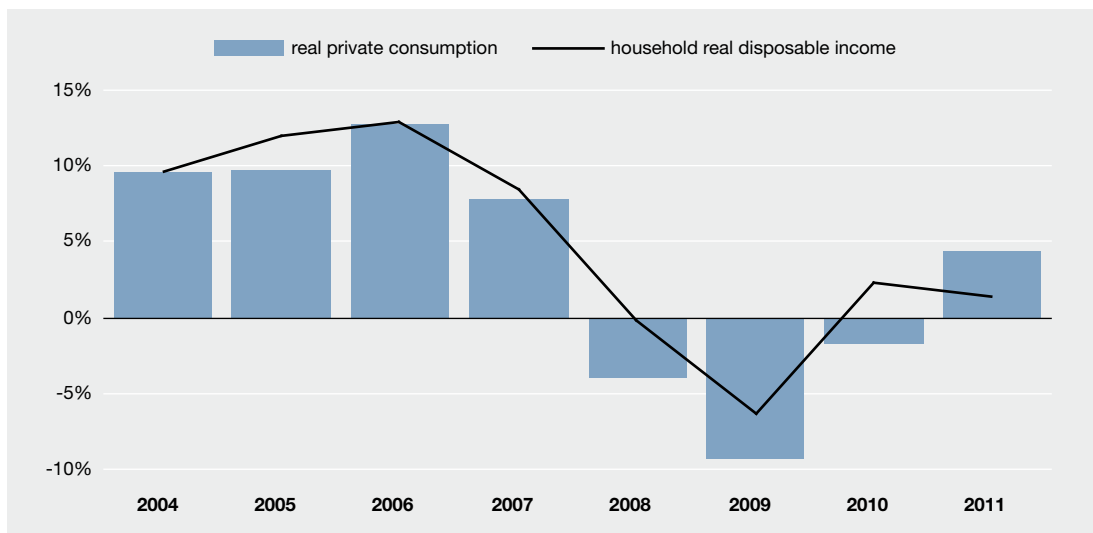


Figure 6. Growth in real private consumption and household real disposable income

Sources: Statistics Estonia, Eesti Pank

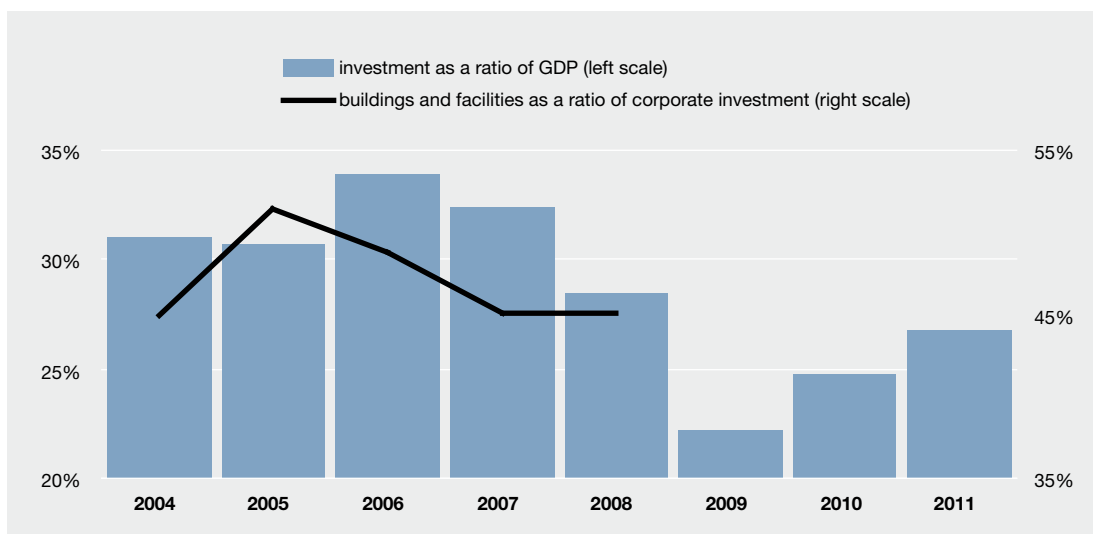


Figure 7. Investment as a ratio of GDP

Sources: Statistics Estonia, Eesti Pank

Investment

Investment generally responds to changes in economic conditions the fastest and relatively sharply. In the years of rapid growth, the share of investment increased by several percentage points and amounted to 34% of GDP in 2006 (see Figure 7). This was supported by favourable interest environment and increasingly optimistic future outlook. A considerable part of the invest-

ment growth can be attributed to the real estate sector (housing and commercial real estate) and related fields of activity. Unfortunately, not all real estate investments contributed to the long-term growth potential of the economy. Although export volumes have increased, growth in exports has remained low. By now, the investment cycle has entered a period of recession.

Similar to the rest of the world, also Estonian companies relied on the financial leverage in previous years, using cheap and easily available loan capital for expanding business. In the last quarter of 2008, however, profits fell back to the level of 2004, which certainly makes loan servicing more difficult. At the beginning of this year, profitability most probably declined further due to weak demand and partly because of the necessary restructuring. Borrowing becomes easier for companies after profits regain growth. In the exporting sector, this can happen at the time the external environment recovers and brings new export revenues to the Estonian economy. Before that, local companies are forced to reduce their loan burden, given the declined income flows. This will definitely not be easy and an increase in the number of bankruptcies is therefore inevitable.

Investment recovery will be boosted by clearer perspectives of the adoption of the euro in Estonia. First, this will increase confidence in the Estonian economy both at home and abroad. Second, loan capital will become cheaper since interest rates will decline along with a decrease

in risk margins. Restoring the reliability of the Estonian economy in the eyes of foreign investors is crucial because this will bring back foreign investment. In previous years, one of the reasons behind the slowdown in foreign investment growth was the lack of available qualified labour, but this is no more an obstacle in the current stage of the economic cycle.

Approximately 30% less investment will be made in 2009 compared to 2008, and the share of investment in GDP will temporarily decline to 22%. This is also below the level of the crisis of end-1990s. In the coming years, investment will increase again as ratio of GDP, partly because of the expectations related to the adoption of the euro. Nevertheless, the levels recorded during the boom will not be attained in the medium term (see Figure 8).

Stocks

Slowing economic growth was accompanied by the accumulation of stocks. This was especially apparent in the field of real estate, renting and business activities where stocks increased to 8 billion kroons in 2008 (mainly owing to unsold

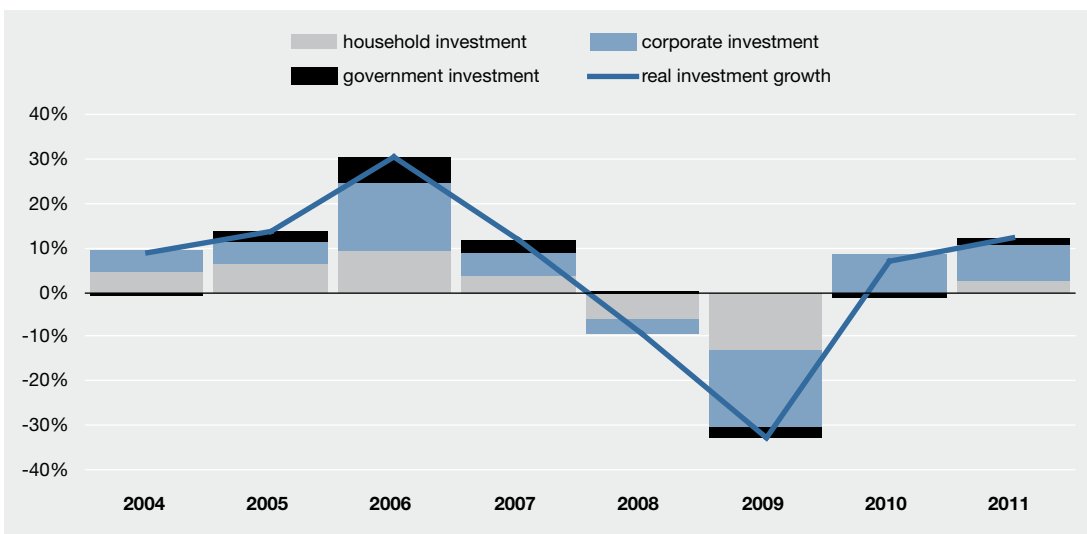


Figure 8. Investment growth components

Sources: Statistics Estonia, Eesti Pank

real estate) but decreased to nearly 7 billion at the end of the year. The total value of stocks in the economy amounted to 75 billion kroons in mid-2008 and 67 billion kroons at the end of the year. A modest decrease in stocks is expected for the first half of the forecast horizon; however, if economic activity increases, the stocks will start to increase again in 2011.

External balance and external debt

For years, Estonia's economic growth has been accompanied by the current account deficit stemming from large investment needs. Starting from 2006, the strong inflow of capital began to boost the current account deficit, raising it to the record high of 18.5% of GDP in 2007 (see Figure 9). The cooling of the economy that started off in the same year caused a turn in this trend and by 2008, the deficit had shrunk to 9.2%, supported by domestic factors. Moreover, it decreased from 13.4% at the beginning of 2008 to a mere 5.1% in fourth quarter. The rapid decrease in the current account deficit continued also at the beginning of 2009.

The trade balance has been the biggest contributor to the improvement of the current account deficit by losing nearly 50% of the deficit at the end of 2008, compared to the record highs witnessed at the beginning of 2007. One of the key turning points for global foreign trade was November 2008 when the financial crisis spread on to foreign trade, dampening trade volumes considerably. This turn of events did not affect only Estonia, but the whole world. The economic growth of Estonia's main trading partners slowed abruptly at that time, which is why in the final months of 2008 Estonia's volume of exports decreased by nearly 20% year-on-year, and at the beginning of 2009 the decline deepened even further (see Figure 10). This, however, could not undermine the improvement in the foreign trade balance, since import volumes diminished faster. The imports and exports of transit goods (the trade of mineral fuels, electric machinery and transport vehicles) has decreased the most. This year, foreign trade will be considerably lower than last year and the foreign trade balance will improve further. This is yet a temporary improvement, which is caused by the rapid contraction

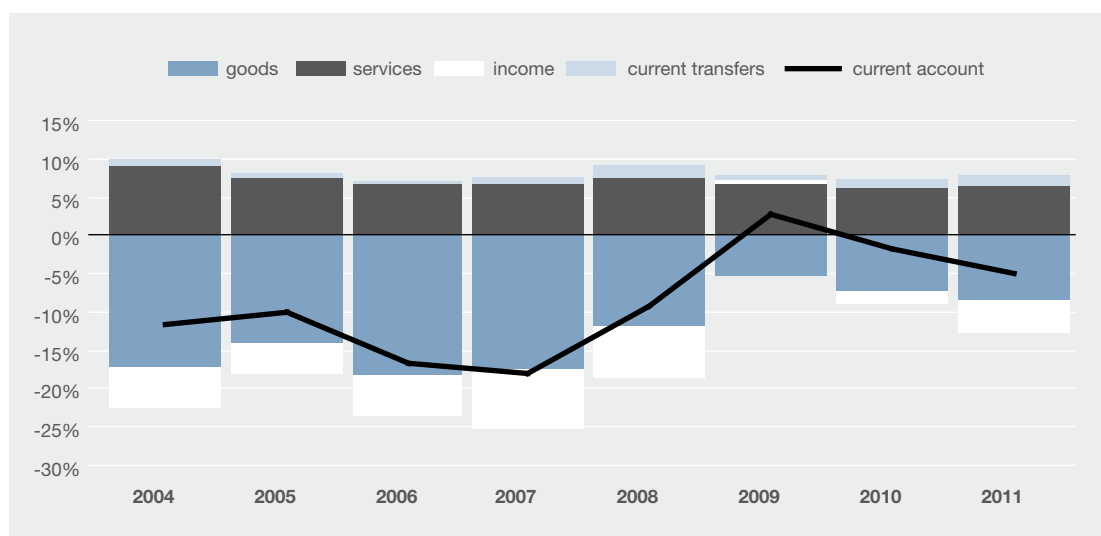


Figure 9. Current account components (% of GDP)

Source: Eesti Pank

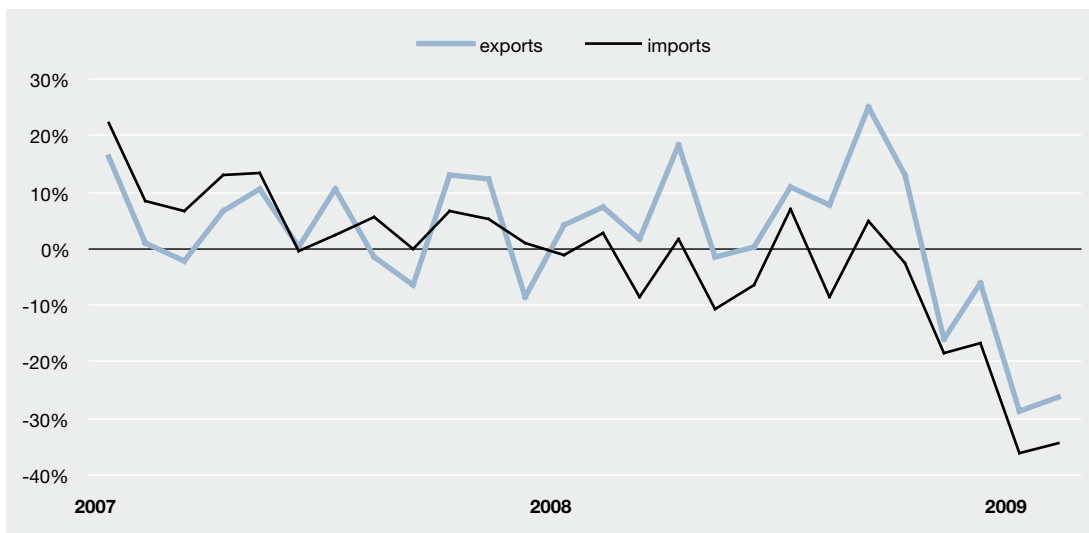


Figure 10. Monthly growth in Estonia's exports and imports (y-o-y)

Source: Statistics Estonia

of the domestic economy. In the new upward cycle Estonia will again need more investment goods for growth and foreign trade deficit will start to increase. As confidence recovers, also consumption will pick up.

The growth cycle of Estonia's exports will largely depend on the ability of the global economy to survive the crisis, but above all on the economic recovery of our primary trading partners. The lower cost of domestic factor inputs, which has passed through to the export prices, could also improve Estonia's position in international price competition. According to the Estonian Institute of Economic Research, Estonian manufacturers could sense a decrease in their competitiveness both in the domestic and EU market already in 2006. For the last six months manufacturers have perceived that the situation is deteriorating, with the indicator of competitiveness sinking to a historical low. Even though this does not prove that Estonian enterprises are falling behind in the context of price competition, lower export prices would help to increase demand. The exporting sector has reacted to the current market situation by reducing demand for labour, implementing

more flexible work hours and schedules on the one hand and laying off employees on the other. The current excess production capacity enables to quickly increase exports once demand picks up again.

Cross-border service providers were better off in the second half of 2008 compared to foreign traders. This is reflected by the stable volumes of both loading/unloading and rail transport in that period. The surplus on the services account has been less dependent on Estonia's economic cycle. According to the spring forecast, the surplus on services will be 6–7% of GDP, although there is a risk that the global economic crisis may slightly reduce it.

The income account deficit has increasingly been boosting the current account deficit. This indicates the profitability of foreign enterprises in Estonia, with a considerable part of the profits belonging to the banks operating here. The recession will reduce profitability, bringing about a temporary surplus on the income account in 2009. At the same time, the number of people working abroad will decrease and their wages

will decline too. Eventually, the income account will start posting larger deficits again in the longer term. The current transfers account received additional funds in the extent of 1.9% of GDP in 2008. This year, the inflow of these funds will decrease, as the EU funds of the previous funding period will be exhausted, whereas the funds available for the new financial perspective are still scarce. To some extent this will also be affected by the shortage of self-financing.

The decline in the current account deficit points to a decrease in Estonia's foreign financing needs, and external debt growth has slowed. In 2009, even less foreign funds will be raised. The rapid growth in external debt in the last years stabilised in 2008 at 298 billion kroons. Next year, Estonia will repay a part of the external debt and in 2011 the debt will total 265 billion kroons.² However, due to the contracting of the economy, the ratio of external debt to GDP will continue growing in 2010. The private sector will reduce its external liabilities, but the general govern-

ment will probably finance the budget deficit through external borrowing. The external debt of the general government will increase by 8 billion kroons to 7.1% of GDP (see Figure 11).

A significant part of the capital used for financing the Estonian economy consists of capital flows between parent companies and their subsidiaries. For example, the banking sector's external liabilities to parent banks account for nearly 40% of the external debt. Among the non-financial sector enterprises, too, the majority of the subsidiaries operating in Estonia are financed by the parent companies abroad. Such financing structure reduces significantly the exposure of the Estonian economy to the traditional capital flight.

Labour market

Although the first signs of economic downturn emerged already in 2007, some employers were facing labour shortage even in the middle of 2008.

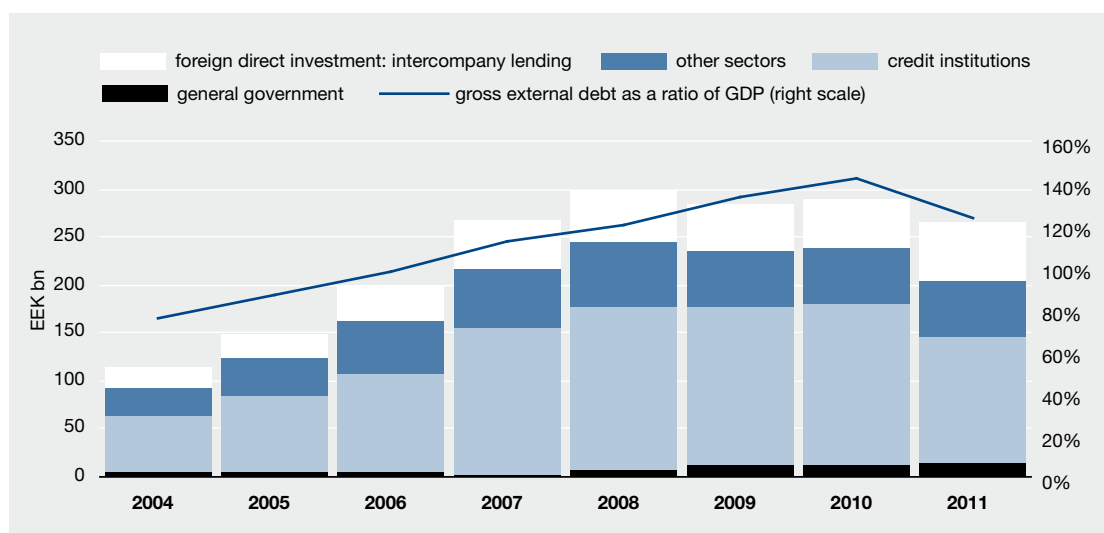


Figure 11. External debt components

Source: Eesti Pank

² When the minimum reserve requirement will be reduced from 15% to 2% at the time Estonia joins the euro area, banks' external liabilities to parent banks will decrease.

For the employees, however, these were good times. The unemployment rate³ for the second quarter of 2008 was 4%, which is the record low level. Third-quarter wage growth reached nearly 15%, even though the economy was already rapidly declining. The labour market's slow response to the lowering economic activity probably stemmed from companies' unwillingness to let go the employees they had managed to find for high cost only a while ago. At that time, the economic downturn was probably seen as a temporary correction.

In the fourth quarter of 2008, the global financial turmoil started to have significant impact on consumer confidence as well as the operation of manufacturers and trading companies. At the same time the labour market went through rapid changes driven by the abrupt decrease in production output and orders. Wage growth decelerated fast and stood at 1.6% in December, year-on-year. The sharp decrease in wage growth was, among other factors, driven by lower performance pays in 2008 compared to 2007. The fourth-quarter

growth rate was 6.9%, but in annual average terms gross wages increased 13.8%. Based on the data on tax revenues, wage growth slowed also at the beginning of this year, and it may be that in February wages were already lower than a year ago. Average gross wages grew 77% in 2005–2008 and real wage growth reached 38%. Productivity per employee increased only 15% in that period, which is several times less than real wage growth. The spread between productivity and wage growth is one of the main imbalances to unfold in the course of restructuring in order to restore growth (see Figure 12).

The slowdown in wage growth at the end of last year will be replaced by lowering of wages this year. In the first quarter, average wages may still grow slightly on a year-on-year basis, but will then decrease starting from the second quarter. In some fields, only performance pays and other bonuses will be cut, whereas in the sectors that increased their loan burden more in recent years and saw also stronger wage growth, the decrease in basic wages will probably be inevitable. Public

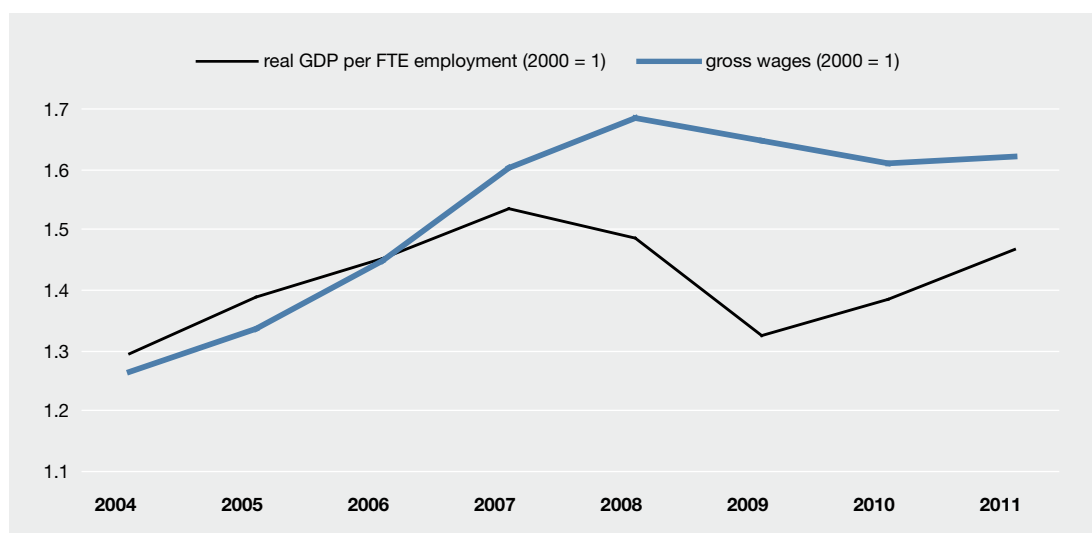


Figure 12. Gross wages and productivity

Sources: Statistics Estonia, Eesti Pank

³ Estimated by Statistics Estonia based on ILO methodology.

sector wage growth has exceeded private sector wage growth for the past few years, which has partly offset the smaller wage growth of earlier periods. In 2009, wage costs will decrease also in the public sector. Average gross wages will decline from 12,818 kroons recorded in 2008 to 12,151 kroons in 2009, and a further decrease is likely also in 2010. Wage growth will recover only in 2011 (see Figure 13).

Wages are nevertheless sticky downward since, pursuant to the Employment Contracts Act, it is much more difficult to lower wages than to raise them and many employees might not be willing to agree to a decrease. Yet, the large number of the unemployed who are willing to work for smaller wages and fear of losing one's job considerably decrease employees' advantages in wage negotiations. For this particular reason, strong wage pressures can be expected also next year.

Owing to weakening of total demand, the demand for labour has also decreased remarkably and employers are busy with bringing the number of employees in line with the demand. Several approaches are used for this purpose. Some

companies regard the drop in workload as temporary and are thus implementing part-time working hours or holidays with partial pay, while others prefer lay-offs. Fixed-term employment contracts are extended considerably less often than before, and the same applies to the extension of contracts after probationary period. Companies are cutting also other labour-related costs, for example training expenses. By the end of this year, the number of the employed will decrease to 622,000, which is nearly 35,000 less than in the last quarter of 2008. By the end of 2010, the number of the employed will decrease by 12,000 more people to 610,000 (see Figure 14).

However, the increase in the number of the unemployed will not match the decrease in the number of the employed. Some people prefer inactivity; some people come back from abroad to find a job in Estonia, go abroad or become discouraged. Finding employment abroad is not as easy as in previous years because the global financial crisis has brought along a downturn also in those economies that have so far been the target countries for job-seekers from Estonia. Moreover, some of the Estonian residents working in those

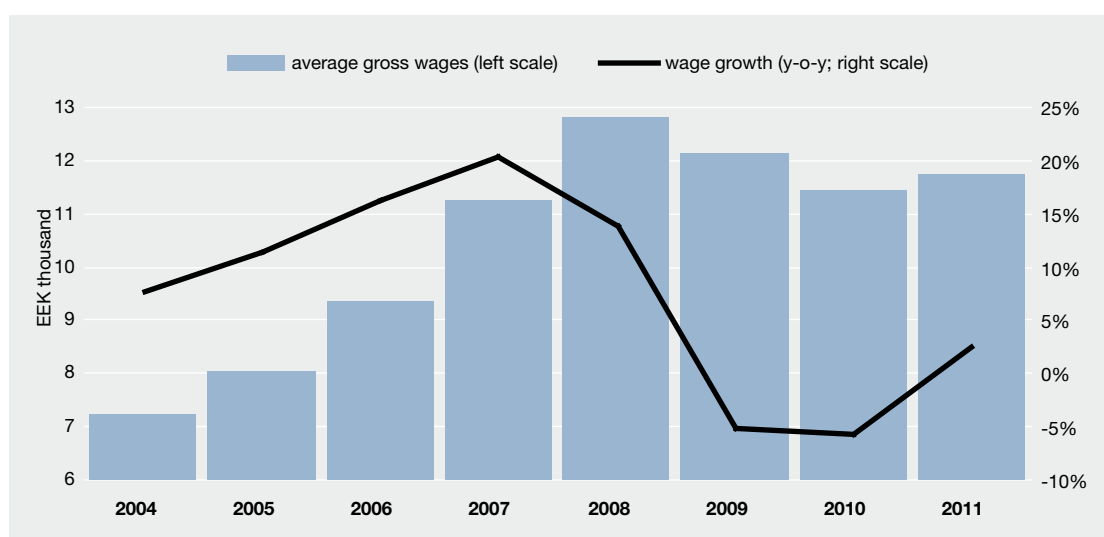


Figure 13. Wage growth

Sources: Statistics Estonia, Eesti Pank

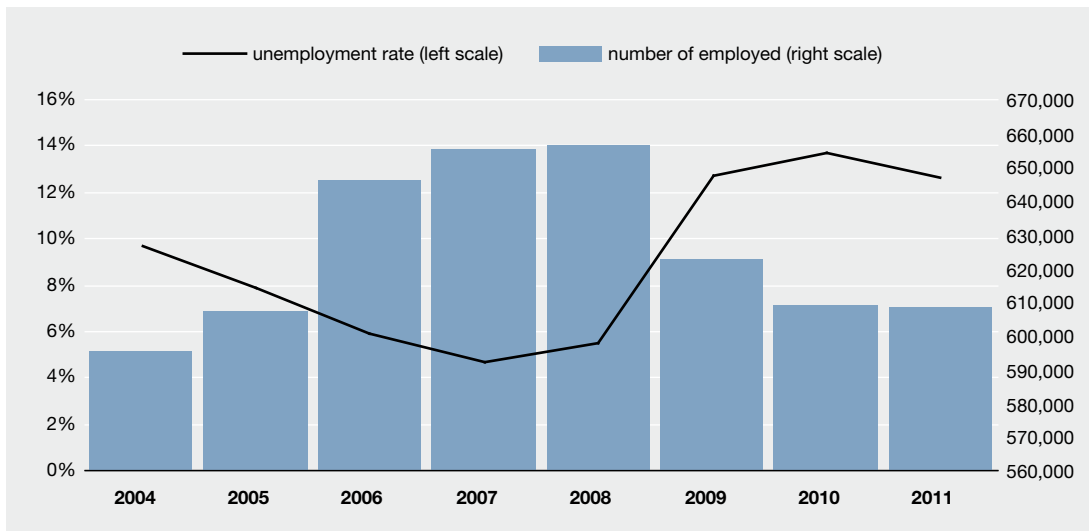


Figure 14. Number of employed and unemployment rate

Sources: Statistics Estonia, Eesti Pank

countries are returning home to find a job here, which brings additional pressure on the social benefits system.

Given that the economic low is not temporary and the demand for labour will not begin to grow in the near future, the share of long-term unemployment will increase and bringing the discouraged back to the labour market will be quite expensive in the coming years. Unemployment entails large social costs and that is why it is important to contribute to the re-training of the unemployed right away and keep them motivated to find a new job. According to the spring forecast, the number of the unemployed will rise from 53,500 in end-2008 to 98,000 in the last quarter of 2009, which means that the unemployment insurance premium will be almost 14%. At the same time, the share of structural unemployment will grow. The unemployment rate increased sharply at the beginning of this year, probably reaching some 10%. According to the spring forecast, there will be 97,000 unemployed persons in Estonia at the end of 2010, which will bring the unemployment rate to nearly 14%.

The economic decline made it more difficult for the labour market entrants to find a job, as the creation of new jobs slowed. In addition, the number of graduates entering the labour market has increased in recent years, which reduces the number of the inactive, but at the same time increases youth unemployment.

Inflation

Prices responded to the upward trend in the economic activity in 2005–2007 with some delay. In 2005 the Harmonised Index of Consumer Prices (HICP) posted 4.1% growth, and 4.4% and 6.7% in 2006–2007, respectively. Although tax increases contributed substantially to inflation, robust economic growth also prepared the ground for significant price increases. Moreover, strong external price pressures started to emerge in the second half of 2007.

In the first three quarters of 2008, price growth exceeded 10% and the annual average was 10.6%. The main reason for the increase was the sharp rise in global oil and food prices. The

increased prices of import energy had an indirect impact on consumer prices throughout the second half-year and thermal energy prices grew 32%. The double-digit inflation rate was not sustainable for the Estonian economy, as it contributed to the gradual decrease in economic activity. Along with this decrease, inflationary pressures started to ease. Global oil prices also started to fall quickly in the second half of 2008. By February 2009, the annual growth rate of inflation had decelerated to 3.9%, and compared to October 2008, Estonia's price level dropped 1.5%. At the beginning of 2009, upward price pressures were caused mainly by administrative measures. As a result of indexation, the prices of several utilities rose in January. This together with the excise duties imposed on electricity increased the CPI in January nearly 0.4%.

The inflation of the last months indicates the beginning of nominal economic adjustment, which will continue in the coming years, since a part of the rapid price growth of previous years needs to be offset. According to the spring forecast, Estonia will experience deflation in the

second half of 2009 on a year-on-year basis, which will persist until the end of the forecast horizon. Deflation will be the fastest probably in 2010, but its extent largely depends on the price rigidities in the services sector. We expect the price decrease to be 0.5% in 2009 and 2.9% in 2010 (see Figure 15). In the first half of this year, deflation will be facilitated also by the decline in import energy and commodity prices (see Figure 16). Estonia is likely to meet the Maastricht inflation criterion at the end of 2009.

The prices of export goods, including commodities, will fall in the forecast horizon, because the lower cost of factor inputs will pass through to the sales prices of products. However, Estonia is and will be a price taker on the global market and the local economic situation cannot significantly affect the price levels of exports and imports. The competitiveness of companies on foreign markets will be supported by the decrease in nominal wages and unit labour costs, which will balance the effects of the strengthening real exchange rate in recent years.

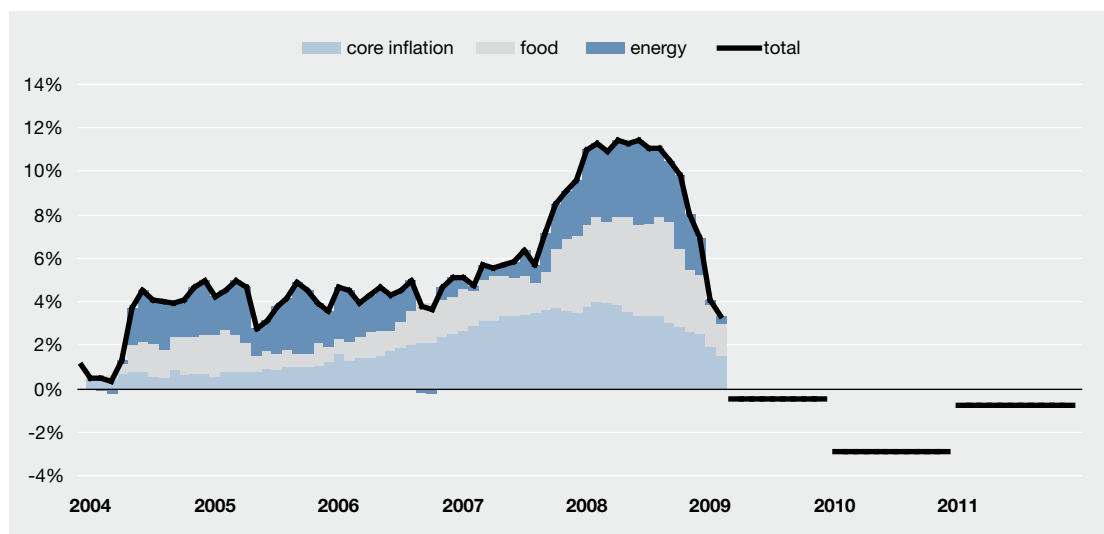


Figure 15. Inflation components and forecast

Sources: Statistics Estonia, Eesti Pank

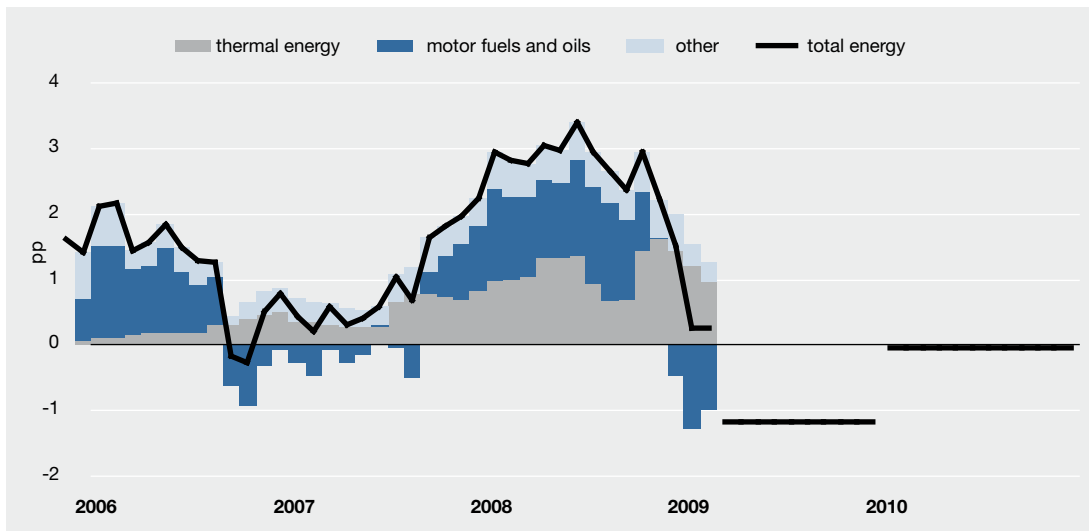


Figure 16. Contribution of energy prices to annual CPI growth

Sources: Statistics Estonia, Eesti Pank

Price expectations

According to the Estonian Institute of Economic Research, inflation expectations of both the households and companies have decreased to historical lows, which points to approaching deflation. Faster price declines can be expected in the export sector open to foreign competition. In recent months, the price expectations of domestic operators (e.g. the food industry) have also become considerably more pessimistic. In the construction sector, as at February as much as two thirds of companies find that lowering prices over the next three months is inevitable owing to excess production capacity.

Consumer confidence regarding a further price decline has grown too. In February, 22% of consumers believed that prices will drop over the next 12 months. Consumers' price expectations together with the worsening financial situation of households might have a great impact on consumption. At the same time, postponement of consumption might lead the economy to an even deeper decline.

Administrative measures

Administrative price pressures are among the few factors boosting prices this year. The beginning of the year saw a rise in the prices of utilities and the price of electricity (the latter increased as a result of higher excise duty). The raising of tobacco and alcohol excise duties in 2008 carried over to 2009 as well.

With regard to the administrative factors, the spring forecast takes account of the price changes of thermal energy and the 2% increase in electricity prices in March.

As regards the administrative measures planned for 2010 and 2011, there is currently little information available. By now, Estonia has fulfilled the obligations proceeding from the Treaty of Accession to the EU regarding the harmonisation of tax rates. Therefore, in the following year the contribution of administrative inflation will be considerably smaller than in the last four or five years.

Food

The rise in food prices in the first half of 2008 was primarily caused by the price hike on the world market, which doubled the contribution of food to CPI growth. The average annual consumer price increase totalled 10.4%, of which 4.3% can be attributed to the rise in food prices. However, from last July to the beginning of this year, the prices of raw materials for food dropped rapidly on external markets. By now, the decline has slowed. The global prices of cereals and raw materials for food have currently fallen back to the pre-increase levels, i.e. the levels recorded at the beginning of 2007. The price of cereals is a very important factor in the formation of prices of processed food. For example, compared to other expenditure the share of feed cereals is high both in the production of meat and dairy products.

Currently, the prices of processed food have dropped in Estonia less than could be expected from the decrease in the prices of raw materials for food. Agricultural prices fell 19% in the fourth quarter of 2008 on an annual basis, but the impact of this decline on the prices at stores has

been very modest. The prices of dairy products declined 5.9% over the past six months, whereas the prices of bread and meat products increased 1.3% and 2.3%, respectively.

In light of economic downturn, the decrease in food prices will be more broad-based in 2009 on account of the profit margins added by retailers. We expect food prices to decrease 3.5% this year. In case exports experience further difficulties, deflation may be even faster.

Motor fuel

In the second half of 2008, global oil prices fell 71% in a very short period of time and are currently fluctuating in the range of 50–60 US dollars. The forecast is based on the assumption that global oil prices will remain below 60 USD this year. Relying on the futures transactions, markets expect a rise in oil prices over the next two years to 55 and 58 USD per barrel, respectively (see Figure 17). Yet there are several risks that could shift the price either upward or downward.

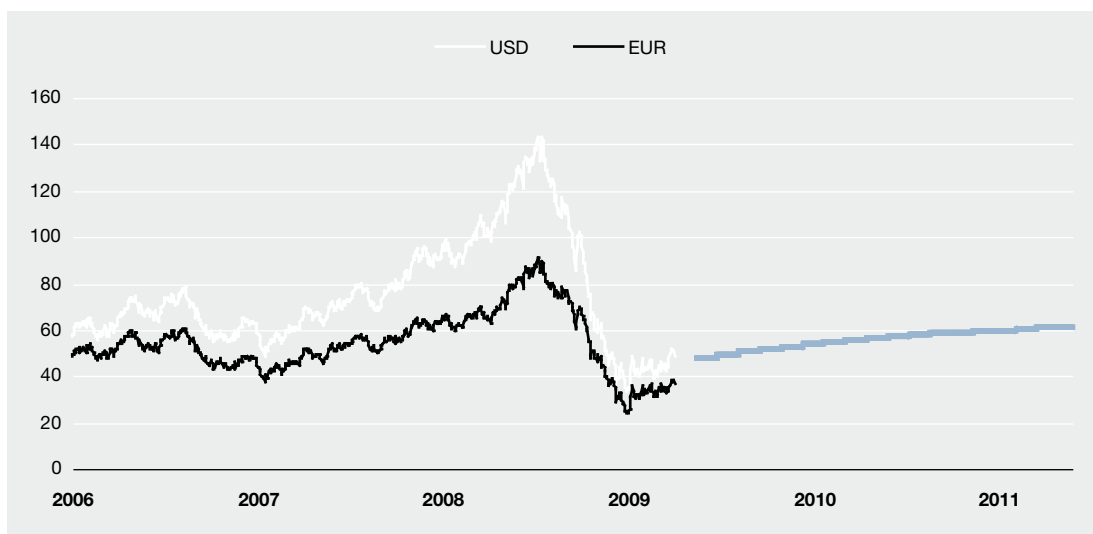


Figure 17. Prices of crude oil and price expectations of markets as at the beginning of March 2009

Source: Reuters

Household energy

The robust increase in thermal energy prices in Estonia started in July 2007, when the VAT on thermal energy was raised from 5% to 18%. After that, thermal energy prices have increased by an additional 57% owing to the rise in the price of imported natural gas. However, in January thermal energy prices started to fall. They will decrease around 30% in the first half of 2009, provided that oil prices do not fluctuate very much. With the price of imported natural gas decreasing, the sellers of thermal energy have to bring prices in line with actual production costs.

Core inflation⁴

The domestically driven inflation slowed rapidly in the first months of 2009. The prices of services are generally more rigid than the prices of goods, since goods markets are more open to external competition. Services account for 23% of the consumer basket and for 57% of core inflation. One of the main factors shaping the inflation of services in recent years has been the overheating of the labour market, but now the

related pressures have abated and in future, the labour market will rather facilitate price declines (see Figure 18).

Price trends of industrial goods are slightly different, but upward price pressures are easing. As expected, the seasonal decline in the prices of clothes and footwear at the beginning of 2009 was more pronounced than in previous years. The price drop of several durables, e.g. cars and home electronics, has continued at an accelerating rate. In the context of considerable real estate price decreases, the reduction in core inflation was greatly influenced by the rents, which were lowered as much as 7.5% in February month-on-month. The fluctuation of energy prices, however, does not affect core inflation much. This fact has been empirically proved also in a study about Estonia.⁵

The core inflation comprises also trends that are contrary to general developments. For instance, as a result of indexing the price of water hiked 9.5% at the beginning of the year. It is impor-

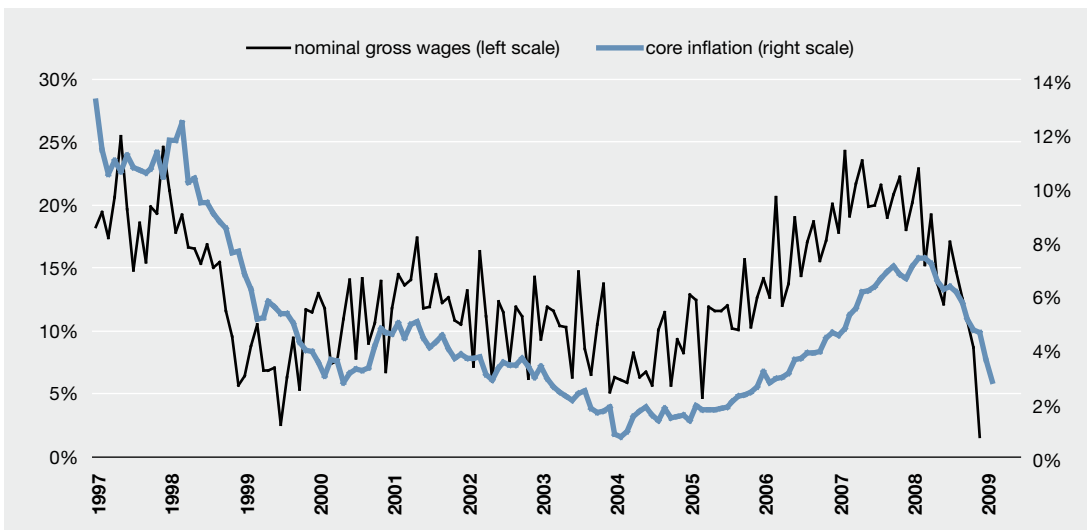


Figure 18. Annual growth in core inflation and gross wages (y-o-y)

Source: Statistics Estonia

⁴ Core inflation is calculated by excluding food, alcohol and tobacco, motor fuel and household energy from the CPI basket.

⁵ E. Stavrev, "Forces Driving Inflation in the New EU10 Members", IMF, 2008.

tant that the monopolistic utility providers would also form the prices according to the changes in expenditure.

In the first half of the forecast horizon we expect the prices of import goods to fall as a result of changes in exchange rates. Estonia's nominal effective exchange rate appreciated 4.5% in February, year-on-year. According to a recent study⁶, such an increase in the nominal effective exchange rate brings about a 1% decrease in consumer prices.

General government

The strong economic growth of recent years has enabled the general government to increase expenditure and income transfers. As a result, the general government budget grew rapidly: from 60 billion kroons in 2005 to around 100 billion kroons in 2008. The ratio of general government expenditure to GDP stayed between 34–35% in 2005–2007, but in 2008 increased to almost 40% owing to the budget deficit and receipts

from the EU budget, regardless of the negative supplementary budget adopted in the middle of the year. As the general government budget posted surpluses in the period of robust growth, it enabled to gather 19–20 billion kroons worth of reserves by the end of last year. (This sum was left after funding last year's budget deficit, which amounted to 2.9% of GDP.)

The sudden downturn that began at the end of last year has started to manifest itself in the collection of tax revenues. This raised the need for a rapid change in fiscal policy, so as to bring expenditure more in line with the level of income. Therefore, a negative supplementary budget was approved at the beginning of 2009, which improved the budget balance by up to 8 billion kroons.

As Estonia has set out to adopt the euro, it is extremely important to keep the state budget deficit within the Maastricht budget criterion. According to the spring forecast, the expenditure included in the supplementary budget for 2009 needs to be cut by an additional 8.5 billion

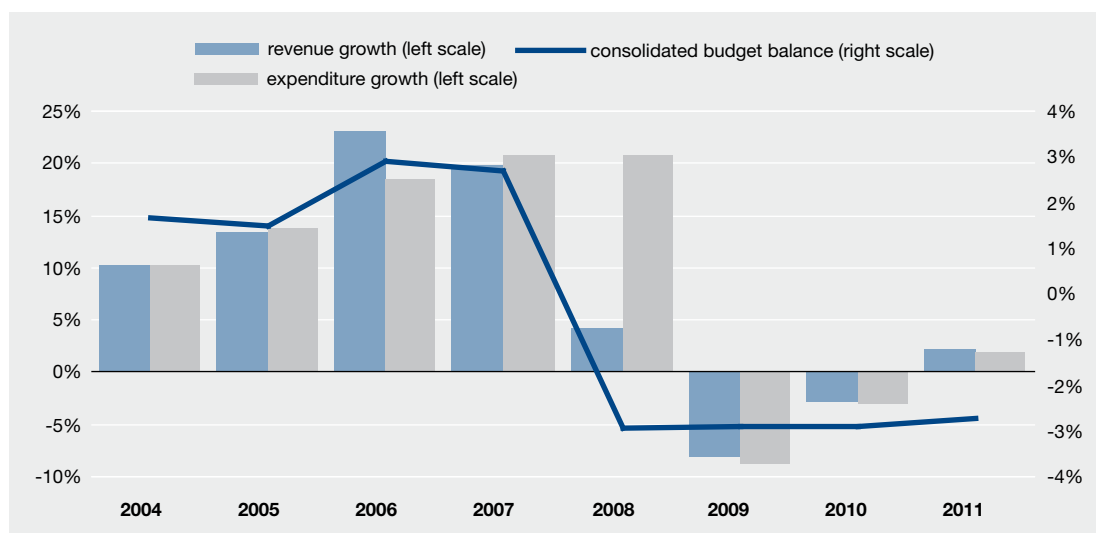


Figure 19. Budget balance (% of GDP)

Sources: Statistics Estonia, Eesti Pank

⁶ J. Beirne, K. Staehr, "Determinants of Inflation in the New EU Countries from Central and Eastern Europe: A Panel Data Approach", 2008.

kroons in order to meet the criterion and bring the deficit to about 2.9% (see Figure 19). The baseline scenario of the spring forecast considers this objective to be realistic. After adopting the supplementary budget the government decided to stop the payments to the second pension pillar in 2009-2010 and started a debate over raising the rates of the Estonian Unemployment Insurance Fund. However, the impact of these measures is not sufficient to keep the budget deficit below 3% of GDP. In connection with the budget cuts, the economic decline will deepen in 2009 but this will be offset by the new growth phase as soon as Estonia can adopt the euro.

As regards budget revenues, it is assumed in the spring forecast that the income tax rate will remain flat at 21% and the non-taxable income threshold at 2,250 kroons.

In addition to the adjustments in this year's expenditure, the government must also review the expenditures of the coming years. Based on the spring forecast, the expenditure planned for the

next year in the medium-term draft budget needs to be cut significantly to keep the state budget deficit within the limits of the Maastricht budget criterion. The forecast relies on the assumptions that general government wage costs will be in line with private sector developments; the ratio of general government's intermediate consumption to GDP will not change, and changes in transfers to households will be made pursuant to the current laws and the macroeconomic forecast. If Estonia is unable to keep the budget at a sustainable level, this will definitely undermine the reliability of the state in the eyes of foreign investors and jeopardise the introduction of the euro. Moreover, also the future expenditure will increase due to loan-servicing.

Based on the fiscal policy related assumptions of the spring forecast, the rapid loosening of previous years' fiscal policy will be replaced by considerable fiscal tightening in 2009. The fiscal stimulus⁷ for 2007–2011 is -2%, -4%, 3.4%, 1.2% and 0%, respectively (see Figure 20). The cyclically adjusted balance that reached

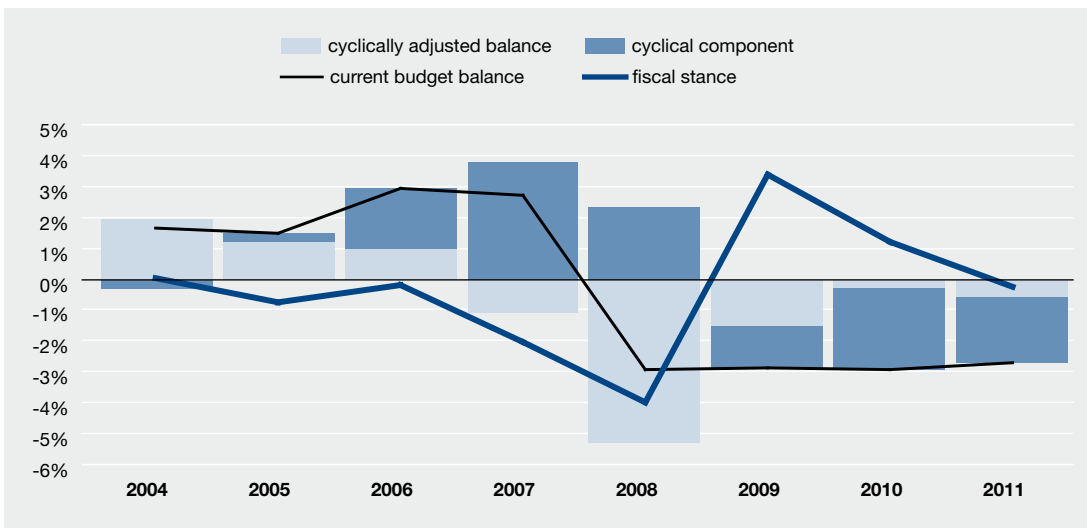


Figure 20. Fiscal stance

Sources: Statistics Estonia, Eesti Pank

⁷ The fiscal stimulus is calculated as a change in the structural balance; the positive sign indicates tightening of fiscal policy, whereas the negative sign denotes loosening.

about -5% by 2008 will be around 0% in 2010. Despite the above, general government expenditure will reach 43% of GDP in 2009 and 2010, which is nearly 8 percentage points higher compared to the average of the last decade.

Banking sector

Compared to the central bank autumn forecast published in October 2008, the outlook for the Estonian banking sector has been revised substantially in the current forecast. In autumn 2008, there was a very strong price decrease on global financial markets, which brought down several major financial institutions. These events made banks across the world much more cautious and brought along adjustments in risk assessment. The sudden deterioration of the financial sector's balance sheets resulted in large-scale interventions by states in order to save this sector. By now, a number of countries have provided considerable support to their banks and have hopefully managed to put an end to the worsening of the situation. Currently, the banking sector is undermined by the non-financial sector, which was also hit by the financial crisis. Banks are no longer the primary

driving force of the economy and the situation on financial markets might still worsen further.

Large uncertainty made the banks operating in Estonia more cautious in terms of lending, despite the high level of capitalisation in international comparison. When assessing the impact of the more cautious behaviour on the economy, it has to be taken into account that in previous years, the banking sector intermediated a considerable amount of foreign savings into the Estonian economy. Eesti Pank warned commercial banks about the risks accompanying the rapid growth of debt burden already in 2003. In 2006, Eesti Pank raised the reserve requirement ratio to 15% and the risk weight of real estate loans from 50% to 100%. Nevertheless, the private sector's loan stock increased from 84 billion kroons in 2005 to 269 billion at the end of 2008. During this period, the ratio of the loan stock to GDP doubled, reaching 108% of GDP by the end of 2008. The majority of loans boosted economic activity mainly in the real estate sector, construction and related business areas. However, in 2007 credit growth began to abate and fell to 7.3% in the last quarter of 2008, year-on-year (see Figure 21).

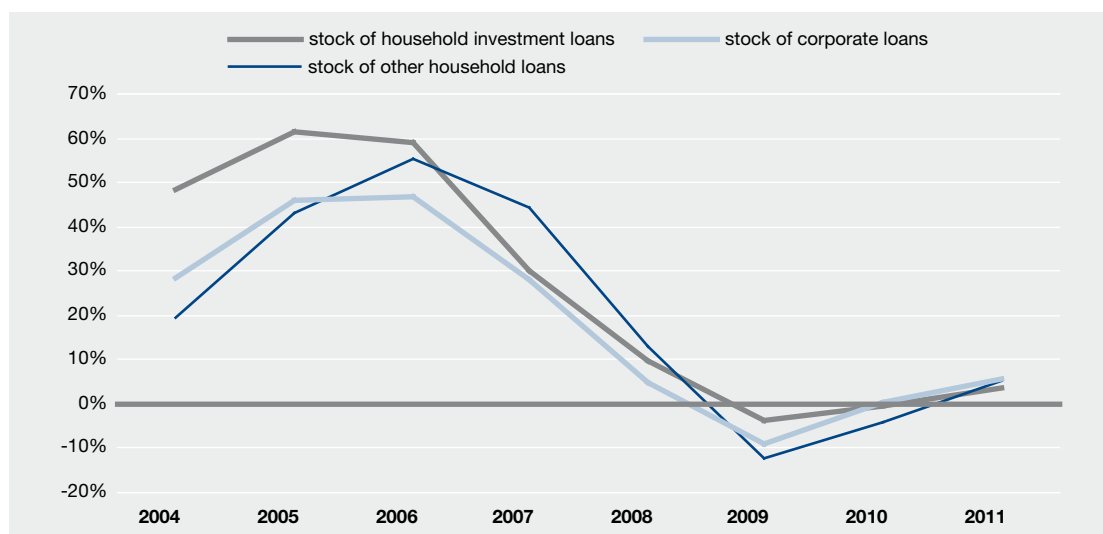


Figure 21. Changes in loan stock (y-o-y)

Source: Eesti Pank

The credit boom was fuelled by low interest rates in the external environment, loan margins that decreased due to strong competition between banks, and optimistic expectations regarding future incomes. In 2008, Estonia's economy landed from the growth-stimulating credit boom to an environment with tighter credit conditions, as banks became more cautious in lending. At the end of last year, tightened financing conditions aggravated the economic downturn, which will also affect the current year.

Given the current capitalisation of Estonian banks and the drop in global money market interest rates, it is likely that the situation might slightly improve. The banking sector has to manage, both this year and the next, with increasing loan losses – an unavoidable side-effect of economic slowdown. Banks' buffers are large enough, but the second-round effects of economic recession on loan portfolios have not emerged in full yet. The forecast relies on the assumption that parent banks will maintain interest in the Estonian market and, therefore, will not change their current financing strategy. Yet this risk still exists, depending primarily on the developments in global financial markets, the

views of investors on Central and Eastern Europe, as well as the scope of second-round effects of the domestic market. Although in the context of recession loan demand is also weaker, it is essential that the banking sector would support the economy in the restructuring process. The lending behaviour of the banking sector will largely shape the further dynamics of the economy. The adoption of the euro at the end of the forecast horizon will restore confidence and thereby also increase loan demand. Yet the financing of enterprises through direct investment might increase in the coming years, which would somewhat crowd out financing via banks. The latter is influenced also by the spread between loan margins in Estonia and Scandinavia.

Corporate credit

Loan demand in 2009–2011 will be affected by the strong growth of debt burden in previous years. The ratio of Estonian corporate bank loans to GDP increased by 23 percentage points in 2004–2007, which is more than in the neighbouring countries (see Figure 22). In 2007, the corporate debt-to-equity ratio in Estonia was one of the highest in comparison with other

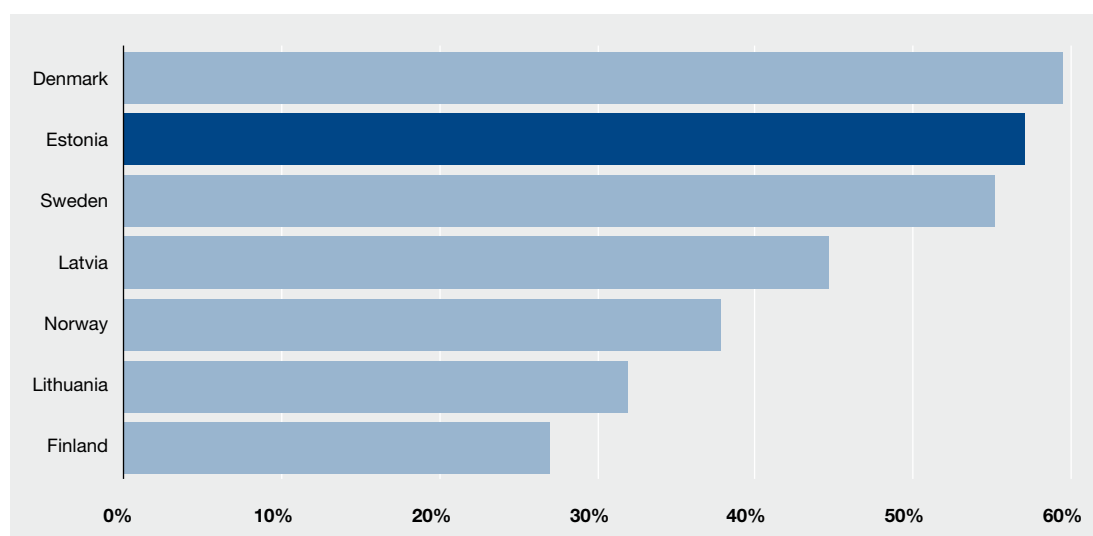


Figure 22. Corporate indebtedness as a ratio of GDP in Nordic and Baltic countries

Source: Nordic and Baltic NCBs

European countries. The debt burden needs to be stabilised due to the corrections in income flows, which is why corporate credit demand will be lower in the following years (see Figure 23). The projects that are based on borrowed funds and have failed as a result of the abrupt decline in demand will no longer be financed. The loan losses will be significantly higher than before, and will shrink banks' loan portfolios both this year and in the years to come. Some enterprises have adopted the attitude of wait-and-see and, given the large uncertainty and the cautiousness of banks, prefer to postpone new investment decisions. Therefore, the amount of loans repaid to banks will be larger than that of loans granted and the loan stock will diminish this year. This process will stabilise by the end of next year.

Considering the current situation on the real estate market, banks are the "market makers", having granted loans to enterprises that want to sell real estate on one hand, and to purchasers of real estate on the other. It is not in the interest of banks to reduce financing, since this would

result in major price adjustments, which in turn would affect the quality of banks' assets. On the other hand, large price adjustments might help the real estate market to recover faster.

Housing loans

In the coming years, the household loan portfolio will be mainly shaped by the improvement of confidence. The expectations about remaining employed and retaining income are vital in this context. Although real estate prices have already fallen back to the pre-boom levels, the purchase of real estate is postponed in the expectation of an even bigger price decline.

The loans granted in recent years with low self-financing ratios have considerably increased the impact of real estate price falls on the net assets of households. With the market value of collaterals decreasing, loan servicing costs might increase because of growing risk margins. Furthermore, with the expenditure increasing and real estate prices falling, consumer confidence will diminish ever further.

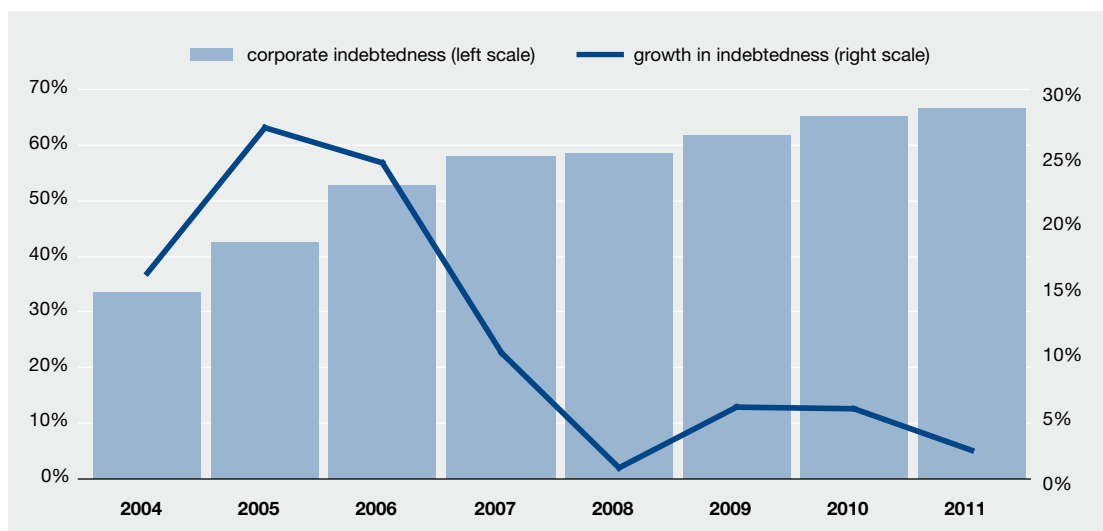


Figure 23. Corporate indebtedness

Source: Eesti Pank

Consumer credit

Compared to other loans, the decrease in consumer credit will be steeper in the coming years, since consumer credit depreciates faster. Households will postpone the purchase of durables as well and will prefer saving over borrowing. The downward trend in the prices of durables will be another motivating factor for postponing consumption.

RISK SCENARIOS

The global economy has slid into the biggest recession of the last decades. External markets send increasingly more unfavourable signals and growth expectations have become more pessimistic everywhere. Financial markets are still volatile and in most countries the crisis has hit also the real economy by now. Several Eastern European countries are seeking financial support and confidence in that region has shrunk. Owing to great uncertainty, it is difficult to provide accurate estimates of even near future developments. Relying on the prevailing opinion, the beginning of the new growth period has shifted to 2010.

The changes in the external environment will affect Estonia through several channels. Exports will be inhibited by the considerable weakening of external demand. To some extent, the exports of goods will be affected also by the appreciation of the euro. Compared to the time of preparing the autumn forecast, there are now difficulties with raising foreign capital. The previous forecast pointed out the decrease in confidence towards Estonia as a risk, and by now this risk has partly materialised.

The adjustment of the domestic economy started off a while ago and has gained momentum ever since. Growing unemployment reduces private consumption, making consumers more cautious. For Estonia, it is extremely unfavourable that the negative developments of the domestic economy coincide with the low of the external environment. Therefore, there are only a few factors that could support growth this year. In short-term, the majority of risks are on the downside, which increases the likelihood of the pessimistic forecast scenario. Although the sources of risks are the same as in the autumn forecast, their extent has been revised (see Figures 24 and 25).

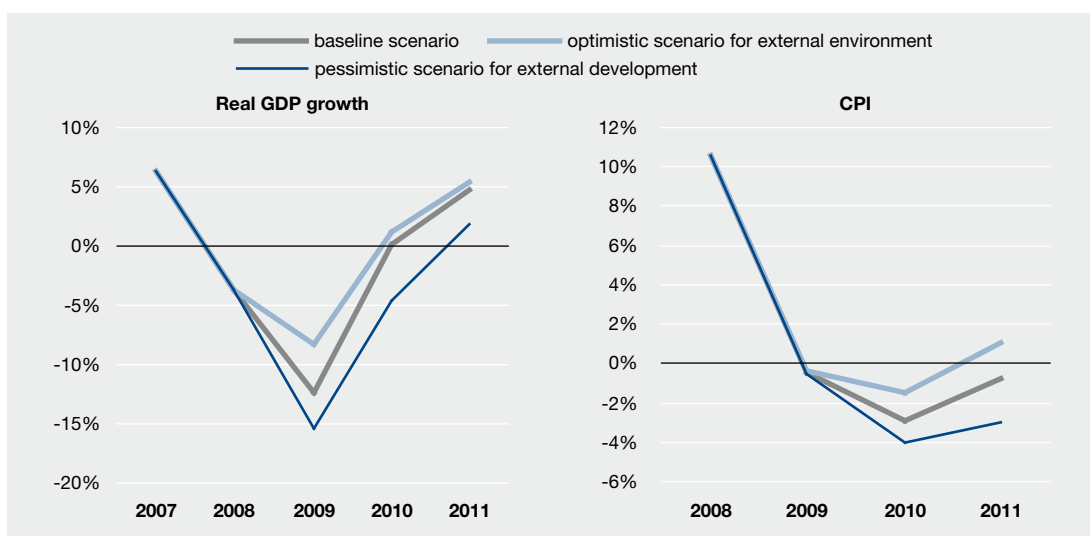


Figure 24. Scenarios for real GDP growth and CPI

Sources: Statistics Estonia, Eesti Pank

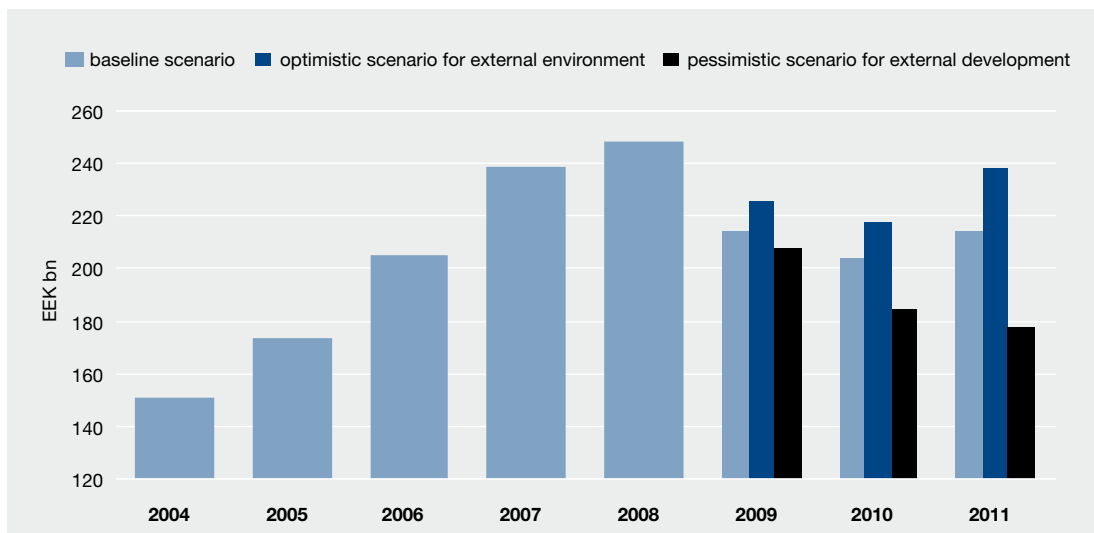


Figure 25. Nominal GDP forecast

Sources: Statistics Estonia, Eesti Pank

Pessimistic scenario for external environment

At the time the autumn forecast was prepared, the evolving main risk was the lack of confidence in the international financial system and the resulting contagion of that risk. By now, this risk has largely become a reality. According to this risk scenario, the problems in the world economy will bring along a longer stagnation and national fiscal and monetary policies will not be able to turn the downward trend any time soon. Interest rates will decrease even further and commodity prices will supposedly also continue dropping.

If the global economic decline continues for a longer period, this will denote a very weak external demand for Estonia. Reaching export-based growth is thus a very painful process. Lower competitiveness might also cause problems and substantial structural changes (including 10% lower wage levels) will be necessary to restore it. According to this risk scenario, enterprises will be facing more difficulties in incorporating foreign capital, which in turn will impede the reor-

ganisation of production. General government investment expenditure will decrease the least, but this will not support economic growth much. Should this risk materialise, extensive reorganisations in the structure of production may be necessary. As regards the budgets of different economic agents (incl. the government budget), the outlook of lower revenues must be taken into account, which is why efforts should be made to keep the expenditure down.

Optimistic scenario for external environment

According to this risk scenario, external demand and confidence of investors will recover faster than suggested in the forecast baseline scenario. This calls for the adoption of the euro as soon as possible. Already this year, external demand will decrease less than suggested in the baseline scenario and will start to grow next year. To this end, the strong effect of national support measures is necessary. Despite a somewhat higher interest rate level, investment activity will increase both in the global economy and

Estonia. According to this forecast scenario, Estonia's export sector will recover quickly. This is favoured by the opportunity of the immediate recruitment of qualified labour.

The increasing confidence towards the Baltic region will result in the recovery of foreign capital inflow. When the crisis starts to abate, it will be possible to raise foreign capital under more favourable conditions and in larger amounts than before. Foreign investors will be attracted by the price level of financial and real assets. The successful efforts of the general government will improve the perspective of the adoption of the euro already in the near future. In addition, the confidence of consumers will increase and as demand grows, unemployment will diminish somewhat faster.

For the optimistic scenario for the external environment to materialise, it is necessary that the key determinants of growth become favourable any time soon.