

Eesti Pank  
Bank of Estonia



# Overview of recent economic developments and the future outlook

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## **OVERVIEW OF RECENT ECONOMIC DEVELOPMENTS AND THE FUTURE OUTLOOK**

### **EXTERNAL ENVIRONMENT**

The global economic outlook has deteriorated since spring and growth indicators have remained volatile. At the beginning of the year, the economic growth of our primary trading partners was still relatively strong, whereas in the second quarter growth slowed considerably. Moreover, the growth outlook has also deteriorated in other countries. Although commodity prices have fallen slightly in the past month and oil prices have dropped nearly 25% from the second quarter peak, they keep inflation high all over the world. Nevertheless, the uncertainty in global financial markets has not hindered Estonian companies and banks from raising foreign capital.

The external environment will probably remain volatile in the near future and no improvement is expected in the second half of the year either.

### **ESTONIA'S ECONOMY**

Estonia's economy is still undergoing an adjustment after the robust growth period, entailing a slowdown in growth. In light of the spring forecast of Eesti Pank it may be concluded that the economy is developing according to the scenario of a faster decrease in domestic demand, primarily in investment growth. Thus, the current economic year might ultimately end in a decline despite the fact that so far, the export sector has been coping satisfactorily. Economic growth is expected to recover in 2009. This, however, calls for relocating resources to strengthen Estonia's export potential.

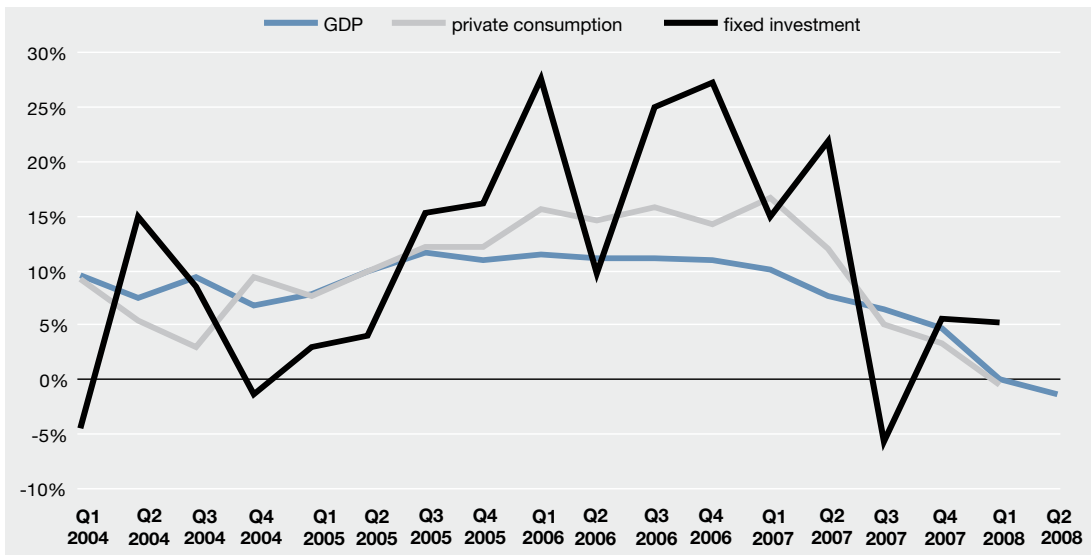
The cooling economy has also brought along clear signs of an improvement in both the internal and external balance. But the risks accompanying the rapid growth of recent years have not disappeared yet. Economic policy makers should take into account that the average growth indicators for inflation as well as average wages are still double-digit. Furthermore, the labour market should react faster to the changing economic environment.

### ***Domestic demand***

Domestic demand decreased in the first half of 2008. In the first quarter, the drop was probably caused by a decrease in private consumption, whereas in the second quarter investment was likely to shrink too (see Figure 1). The decrease in general investment activity was brought about by the uncertainty of private entrepreneurs.

In the first months of the year, investment growth was supported by the continuation of the ongoing major development projects. The fixed investment to GDP ratio still stood at 30% in the first quarter. Thus the decrease in investment, which started in the second quarter according to preliminary estimates, was to be expected.

The changes in household consumption are difficult to estimate, as the uncertainty that emerged in the first half-year was higher than could be expected from the non-financial sector indicators (including average wage and employment growth). The employment figures for the first half-year remained virtually the same as in the same period last year while unemployment posted 4%. The still low unemployment rate may partly be explained by the fact that some people reaching retirement left the labour market. The number of the registered unemployed – people who apply for benefits or require help with finding employment – also indicates a slowdown in economic growth.



**Figure 1. Real growth in GDP and key components of internal demand**

According to preliminary estimates, growth in average gross monthly wages decelerated below 15% in June-July. The slowdown in wage growth was again more apparent in the private sector. The adjustment of the labour market has been slower than expected and the rapid growth in labour costs is still jeopardizing the competitiveness of the export sector. As regards the future, it is unclear how much the impending deterioration of labour market indicators will affect consumers' behaviour.

### **Banking sector**

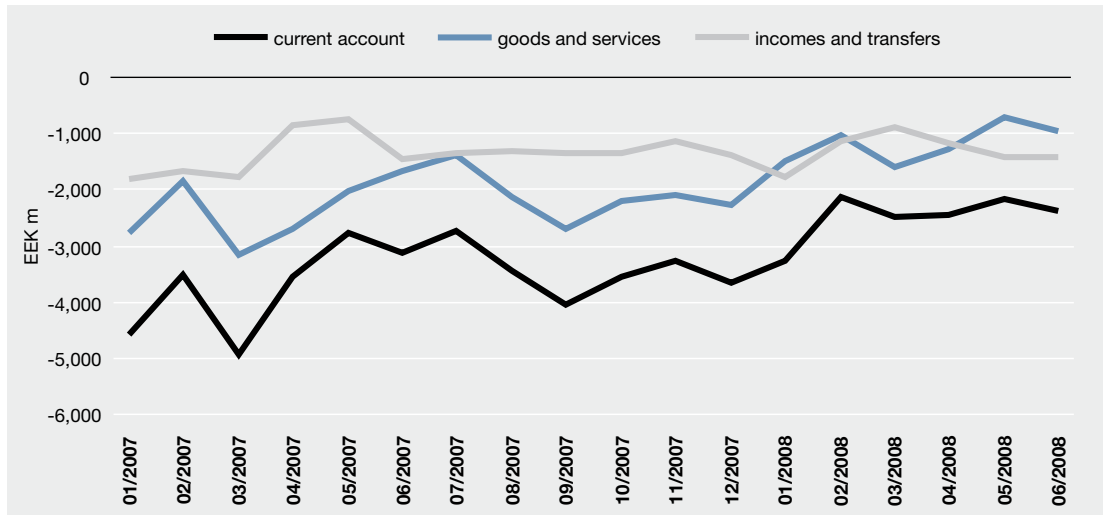
The growth rate of the loan stock has been decreasing further due to the easing in demand. Year-on-year growth decelerated to 17% in July compared to 42% last year. The value of new loans added during the first seven months was nearly 50% smaller compared to the same period last year. The least new loans have been issued to companies operating in the real estate sector – the annual growth rate was 9% in July. The activity and

price changes of the real estate market are also reflected in the housing loan market: the monthly growth rates of new housing loans have dropped to the levels witnessed in spring/summer 2005.

As expected, changes in the economic environment have also affected loan quality. In July, the share of loans overdue for more than 60 days comprised 1.8% of the loan portfolio. A fifth of the loans overdue belonged to companies operating in the real estate sector. The quality of household loans started to deteriorate in the second half of last year (at first owing to the deteriorating quality of consumer credit). The share of overdue household loans started to grow faster in May 2008, but the quality of housing loans is not so poor yet as to pose a threat to financial stability.

### **Foreign trade balance**

Along with the easing in domestic demand that started in summer 2007 also the current account deficit began to diminish slowly (see Figure 2).

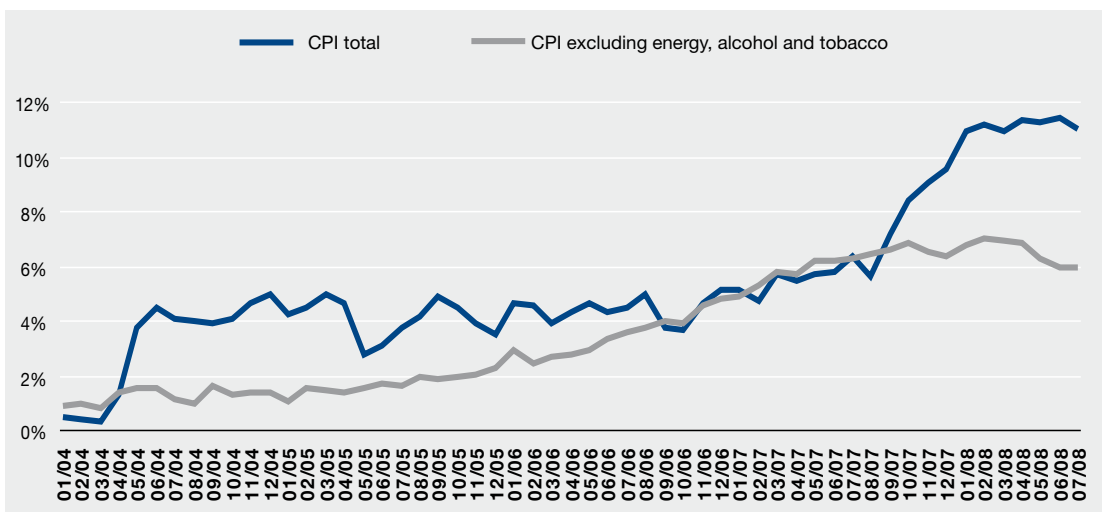


**Figure 2. Current account deficit**

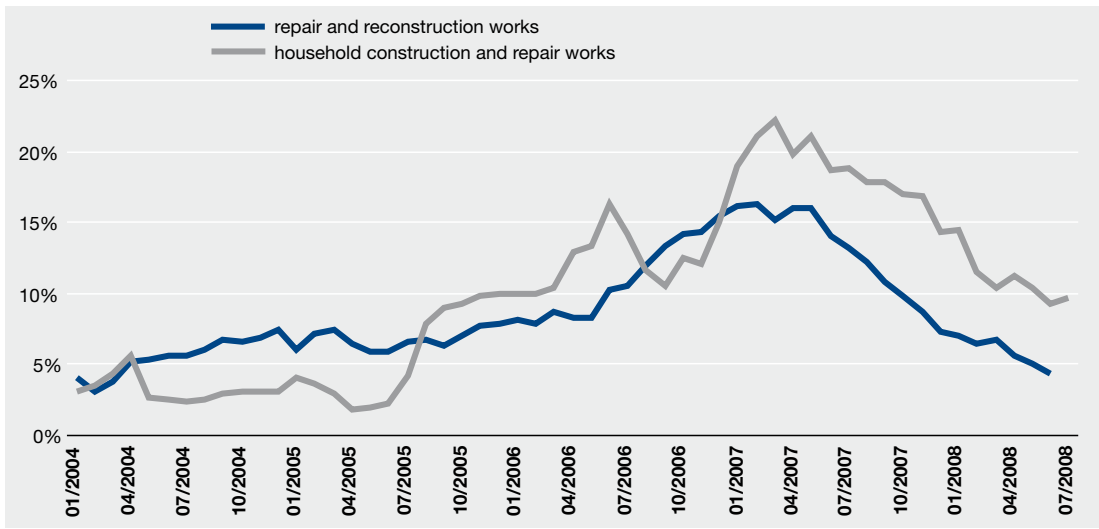
According to preliminary estimates, in the first half of 2008 the deficit decreased to 10–11% as a ratio to the GDP of the same period. The trade balance deficit was nearly as high, reaching the historical lows recorded in 2000–2001. Compared to the old EU Member States, Estonia's current account deficit is still exceptionally high. This indicates that despite a slowdown in domestic demand, there is a continuous need for foreign capital and the ratio of investment to GDP will be exceeding the EU average for quite a while.

In the future, the rate of deceleration of the current account deficit will also depend on the terms of trade. For instance, in June import prices picked up.

As regards capital inflow, direct investment as well as EU structural funds accounted for a larger share than last year. Together with the decreasing current account deficit this means that external debt growth is slowing.



**Figure 3. General consumer price index and core inflation index**



**Figure 4. Price changes of construction and repair works compared to the same period in the previous year**

**Inflation**

The food and oil price pressures emanating from the global market were accompanied by an increase in the excise duties on energy, alcohol and tobacco products in January 2008. Thus, consumer price growth accelerated to 11.1% in the first quarter. In the following months the inflation rate was maintained at the same level by the continuing rise in food and motor fuel prices and the pass-on of high oil prices to heating costs. The core inflation indicators dropped close to the long-term average and the growth of the construction price index declined to 4.3% in the second quarter – the lowest figure since 2004 (see Figures 3 and 4).

In July, the excise duties on tobacco and alcohol were raised for the second time. Compared to June, the cost of the consumer basket rose by 0.7%. Nearly half of the rise could be attributed to the alcohol excise duties imposed at the beginning of the month. In the second half-year, however, the increase in heating costs will be mainly hindering the deceleration of inflation.

Although the annual average consumer price growth will also remain close to 11%, the inflation driven by domestic factors is steadily declining further owing to the general economic cooling.

**General government**

Slower than expected growth in domestic demand means that the budget revenue will be smaller than estimated. The collection of revenues has remained volatile both across months and types of tax. In the coming month, the collection of indirect taxes will probably slightly improve and the growth rate of taxes collected on wages will slow. Nevertheless, the collection of consumption taxes might remain below the initial estimates in annual terms too.

The size of the budget presumes a rapid nominal growth of costs also in the second half-year. The Government adopted a supplementary budget before summer holidays, laying down cuts in expenditure. However, as these cuts do not automatically guarantee a balance between revenue and expenditure, the final budget outcome will

be determined by the actual size of expenditure. In other words, what matters is the extent of the expenditure postponed.

Given the worsening growth outlook, the Government has made significant efforts in preparing the 2009 state budget to curb growth in expenditure and maintain the balance between revenue and expenditure. These efforts are well justified, as in more difficult times conservative fiscal policy is the best measure to guarantee the reliability of the Estonian economy for investors and creditors. A large budget deficit entails the risk that the private sector has to pay for it in the form of higher interests. Considering the 8% nominal growth forecast of the Ministry of Finance and the risks emanating from the current economic situation, striving for a balanced budget for the next year is a reasonable option. Eesti Pank regards it important to prefer budget balance

to other election promises and rather postpone the announced tax cuts. A large-scale and hasty raising of consumption taxes is currently not recommended, as the long-term trends of tax policies have not been sufficiently analysed.

Rapid changes in the economic cycle indicate a need to improve the long-term development of fiscal policies. The Government has confirmed in its earlier decisions, for example in the Convergence Programme updated last year, that the budget must be in surplus in the medium term. This is necessary to cover the expenditure increases related to the ageing of the population, reduce the vulnerability of the economy as well as for international reliability and security considerations. For the sake of future fiscal policy making, it is necessary to specify the size and objective of the budget surplus to be considered when annual budgets are prepared.