

Eesti Pank
Bank of Estonia



Economic policy statement of Eesti Pank

27 August 2008

Focus of the economic policy statement



- Why does economic growth tend to follow the alternative scenario?
- How certain can we be of a deceleration in price growth?
- What should be recommended to the government when they prepare the 2009 budget?

1. How did summer affect economic growth?

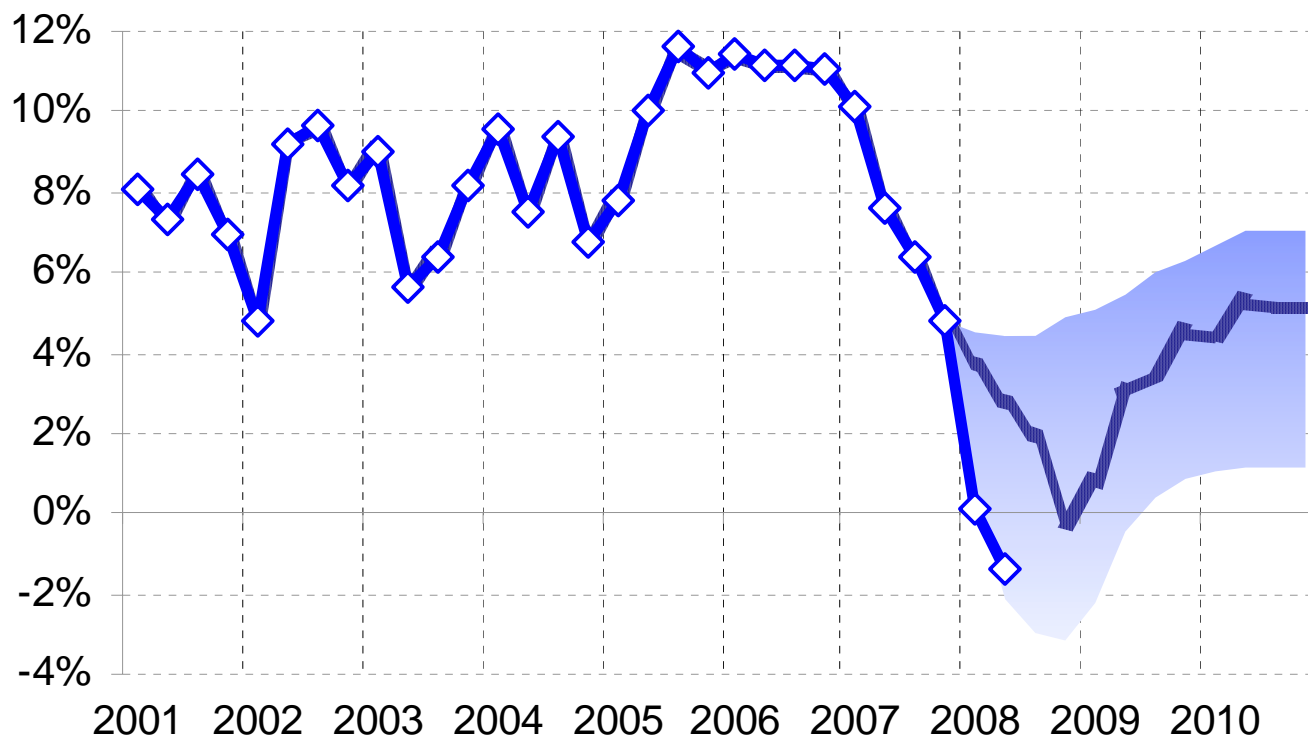


- Economic developments follow the so-called scenario of a faster adjustment of domestic demand
 - Estonian consumers have quickly reacted to the less favourable economic environment and started to save
- The price hike of food and fuel dampened trust and the fun of consumption also elsewhere in the world; the second quarter was especially poor for our trading partners
- The cost of capital has increased in the global financial markets
 - For enterprises, financing conditions are likely to become stricter

Real growth is moving closer to the lower boundary of the spring forecast

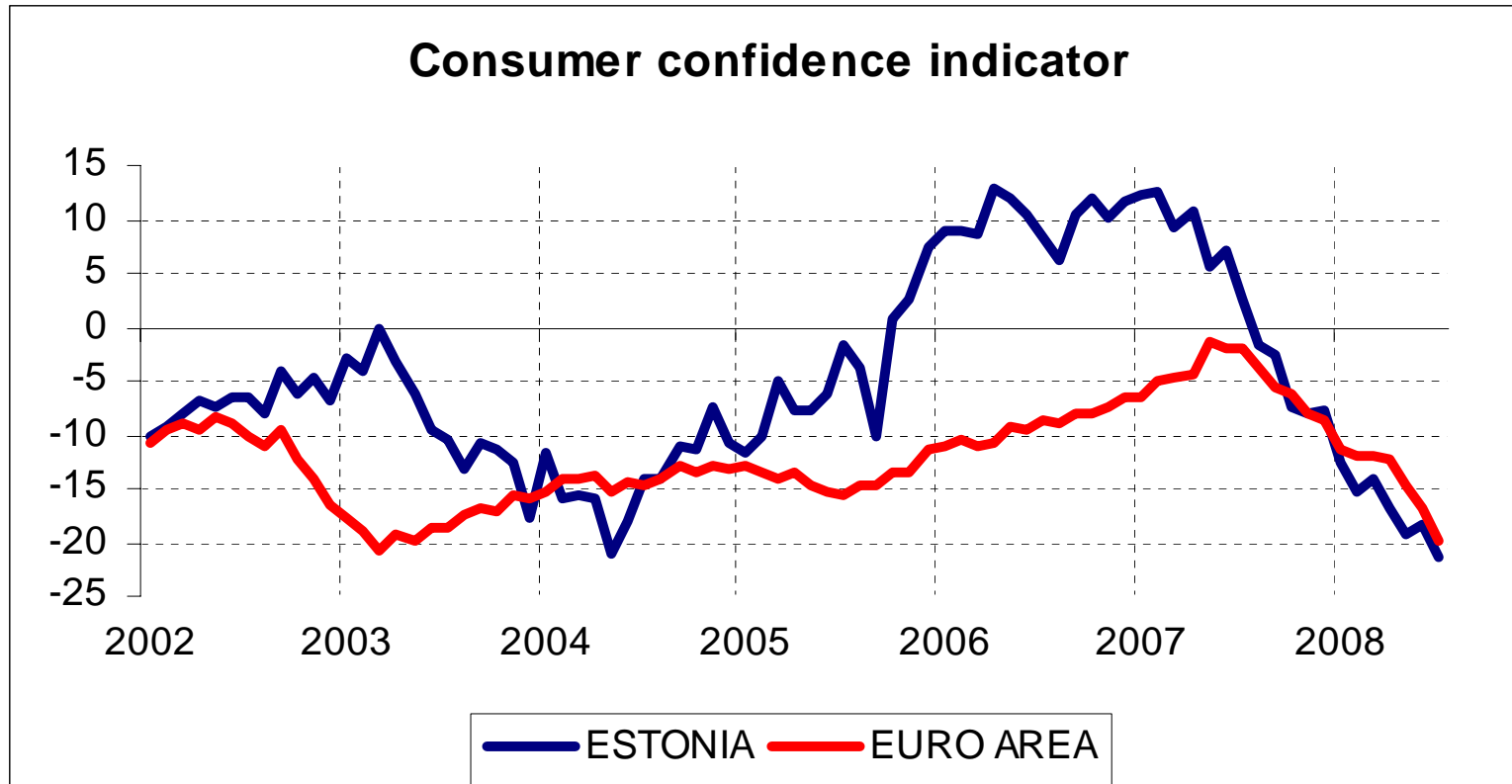


GDP growth in light of the spring forecast



Source: Statistics Estonia, Eesti Pank's spring forecast

The second quarter has been difficult for many of our trading partners



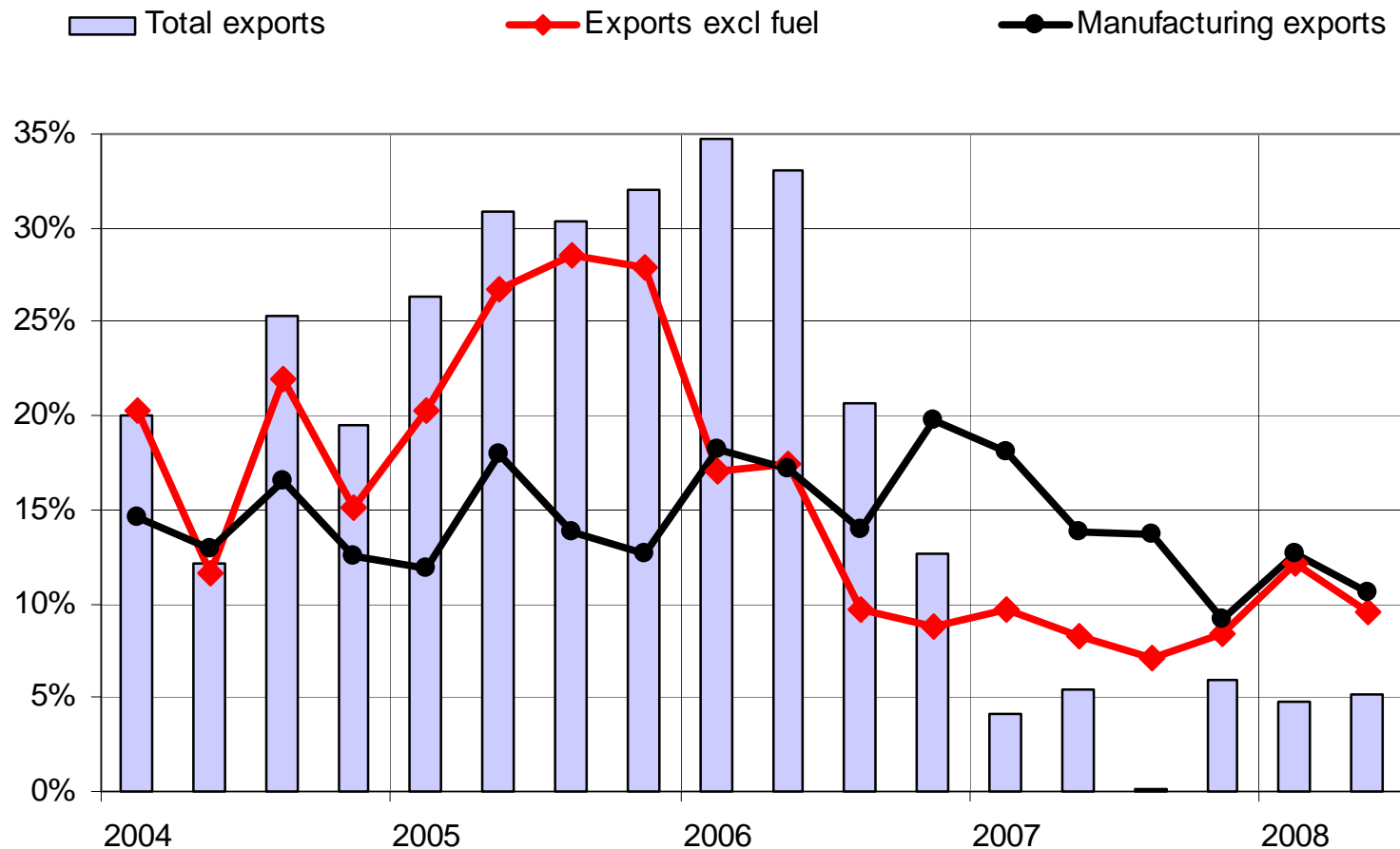
Source: Eurostat

At the same time, the adjustment process has not brought along any surprises

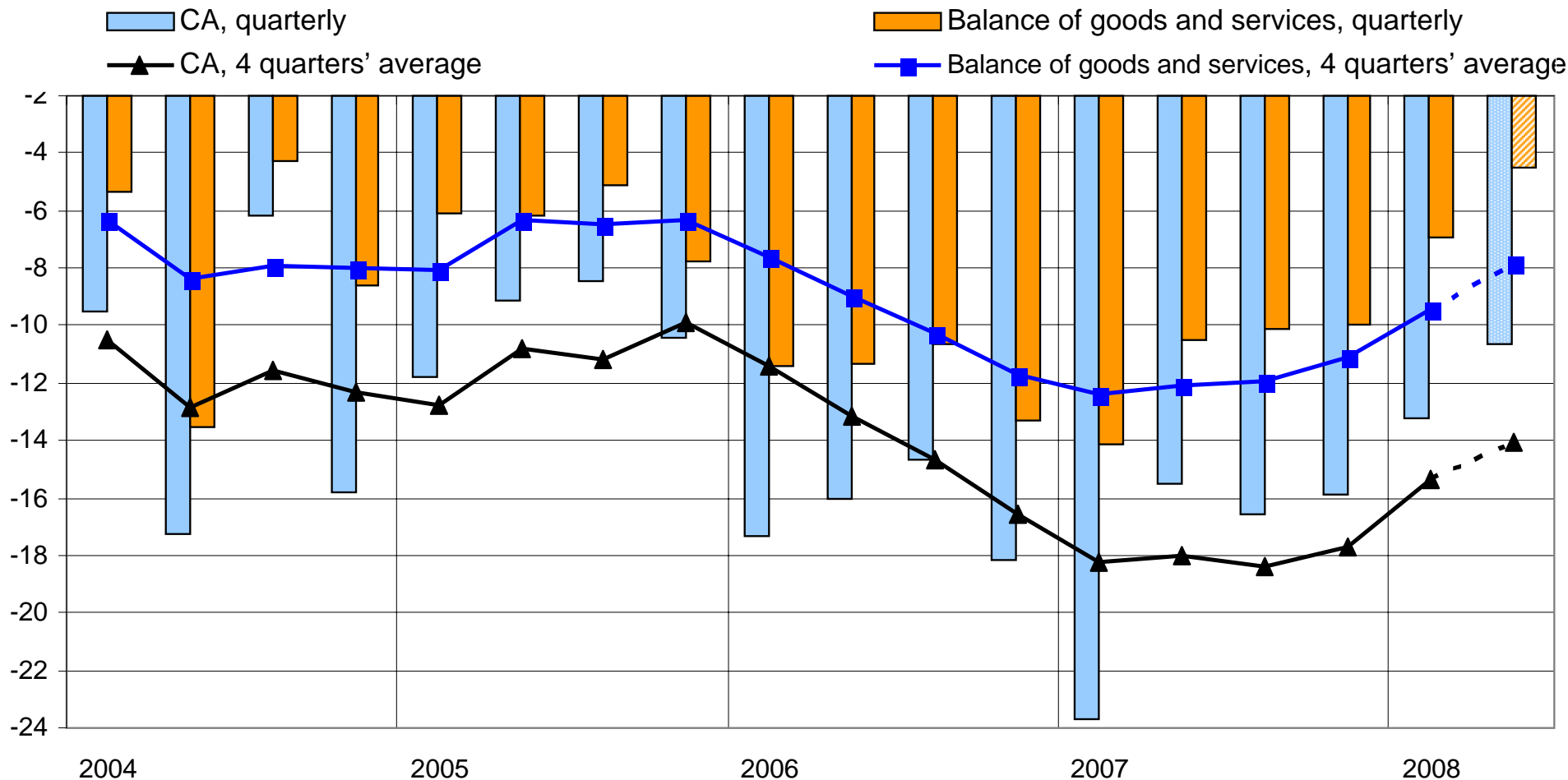


- Regardless of the weakening external environment, the first half-year nominal growth of manufacturing exports was approximately 12% in Estonia
- The financial sector capitalisation remains high, there are no obstacles to financing economic growth
- The budget disputes are, after all, about how rapid the expenditure GROWTH of 2009 will be
 - It is good for a country to have no debt burden!
 - Reserves should be even bigger
- Thus, the mentioned factors will not impede the recovery of economic growth in the course of 2009

The exporting sector has managed well so far

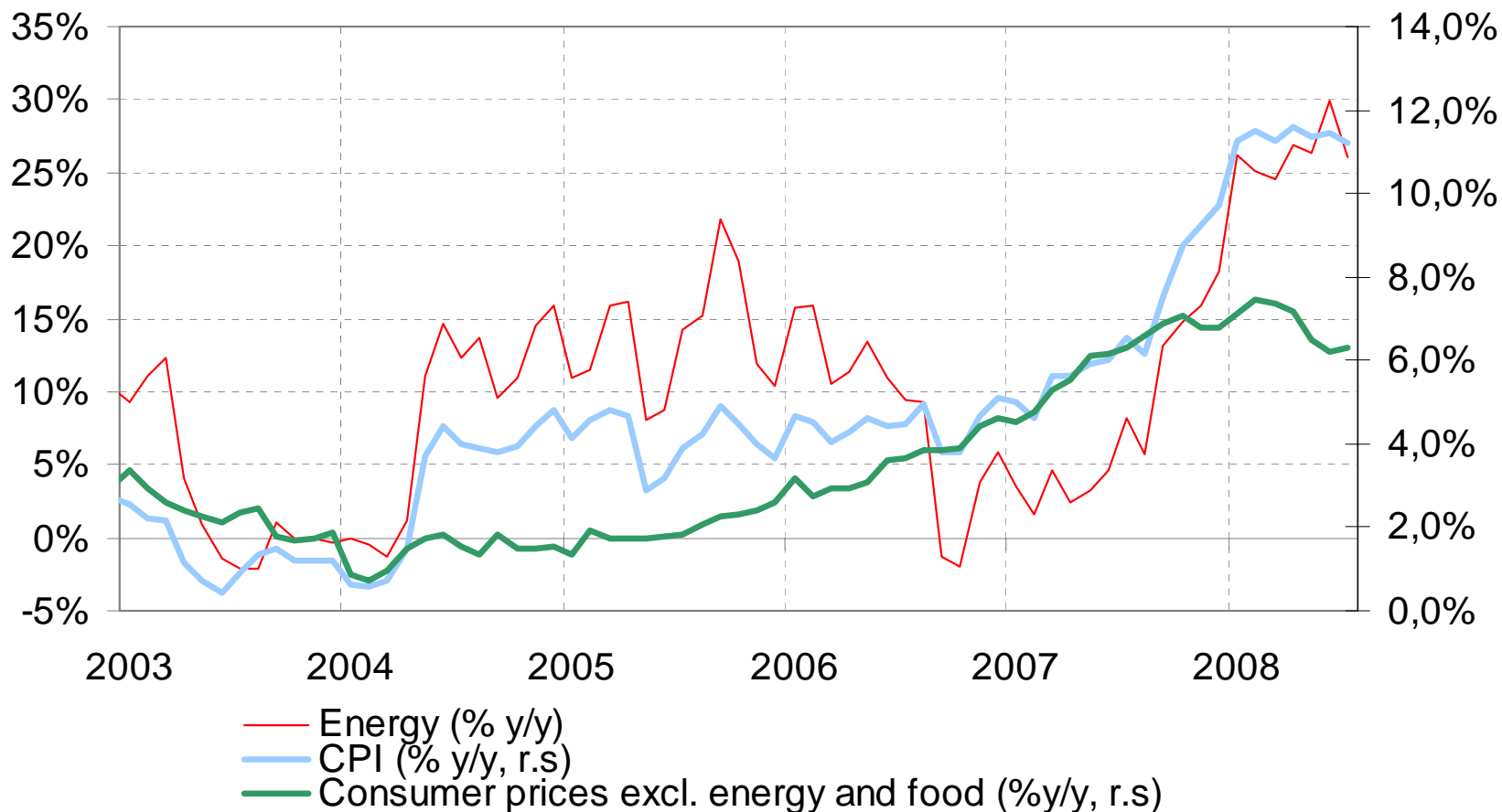


Example: foreign trade deficit has decreased considerably



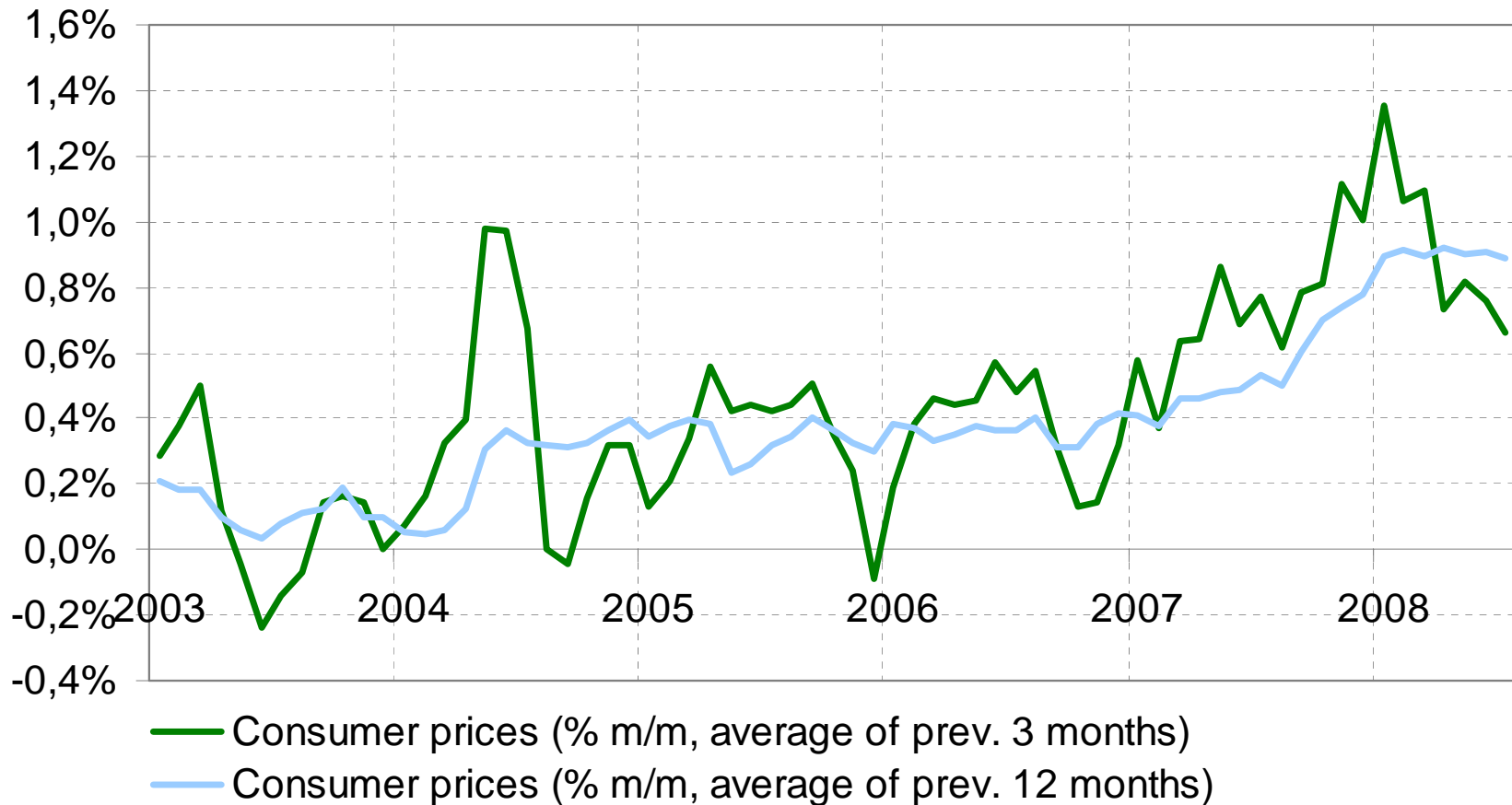
Source: Statistics Estonia

2. Domestic price pressures are already subduing



Source: Statistics Estonia

The rapid annual price hike is primarily a reflection of past events



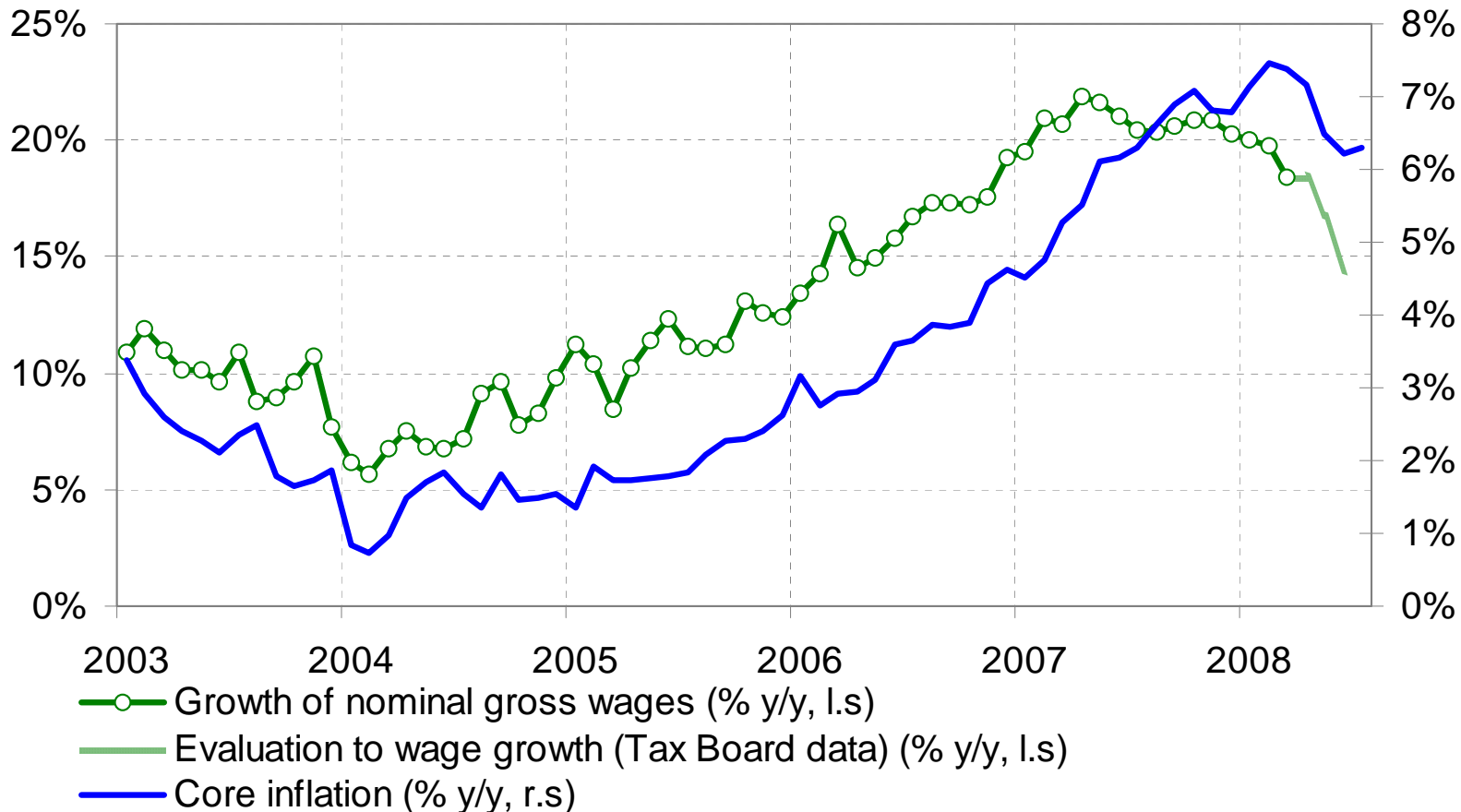
Source: Statistics Estonia

However, it would be a good idea to support the slowdown of price growth



- The spring oil price jumps are partly manifested in the autumn fuel prices
 - Authorities need to see to it that these changes would not be one-sided, i.e., the recent price drop of oil and other inputs must also be reflected in administered prices
- Wage growth has slowed, but..
 - against the backdrop of a fast decline in demand, the price formation of enterprises could be more flexible
- It is better to avoid any price indexation, i.e., the linking of prices to inflation

The abatement of wage growth provides a good basis for the slowdown of the inflation rate



Source: Statistics Estonia

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Conclusions

3. The period of adjustment is tiresome, but cannot be avoided



- After a period of very fast growth, Estonia's economy is undergoing adjustment, which is tiresome, but absolutely necessary, since:
 - the sectors oriented to external demand, incl the exports of goods and services, need more resources
 - the traces of the real estate bubble (e.g., unmaterialised property) must disappear
- A precondition for the recovery of growth is a strong budget and carrying on with reforms - this provides favourable investment conditions for the future
- Unfortunately, the complicated situation of the global economy does not facilitate our economic adjustment

Fiscal balance must be preferred to other election promises



- It is important to continue pursuing reliable fiscal policies, especially considering the current external environment
- According to the recent economic forecast of the Ministry of Finance, the 2009 nominal growth will be a decent 8%, thus the objective is a budget that is at least in balance
- Hereafter, a fiscal surplus is a must, because:
 - costs will increase in the future (e.g., in connection with ageing population)
 - fiscal surpluses support economic security

A realistic budget does not stand in the way of structural reforms



- The rapid increase in budgetary expenditure during the boom was not supportive of economic growth
 - One cannot prioritise all expenditure increases - choices need to be made
 - The necessary expenditure levels must be fitted in the framework of a reasonable economic growth forecast
- The labour market reform must not be put on hold
 - Flexibility helps create new jobs

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Thank you!

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