

Eesti Pank
Bank of Estonia



Overview of recent economic developments and the future outlook

17 February 2009

GENERAL EXTERNAL ENVIRONMENT

Recent indicators refer to continuous economic deterioration in developed countries. Preliminary estimates show that in the fourth quarter of 2008, economic downturn amounted to -0.2% in the USA and to -1.2% in the euro area (see Figure 1). Since economic indicators have been weaker than expected, the future outlook has undergone several downward revisions.

With recession intensifying and energy prices dropping, inflationary pressures have eased in advanced economies and the risk of deflation is rising. For instance, inflation in the USA has already sunk to 0.1%. Declining oil prices are also influencing core inflation, which has receded to 1.8% in both the USA and the euro area. Commodities market prices have stabilised over the past month; the price of crude oil has been fluctuating within the range of 40–50 USD per barrel. The financial crisis has forced the central banks and governments of all major economic regions to take extensive countermeasures. Central banks have considerably lowered their key interest rates, which has markedly reduced interbank interest rates.

The global financial crisis has also put the economies of Estonia's main trading partners under fire. When the 2008 autumn forecast was being prepared, it was assumed our trading partners' this year's economic growth would average to 1.5%, but now a contraction of over 1% can be expected. Considering the large uncertainty surrounding forecasts, even more negative developments cannot be ruled out. For example, Latvia's 2008 fourth-quarter GDP fell by 10.5% year-on-year. GDP dropped also in Lithuania and is expected to shrink in Finland, Sweden and Russia.

THE ESTONIAN ECONOMY

According to Statistics Estonia, the 2008 fourth-quarter fall in GDP amounted to 9.4% year-on-year. For the entire 2008, GDP in Estonia decreased by some 3.5%. Since external demand turned out to be much weaker than expected last autumn, Eesti Pank's autumn forecast was revised in keeping with new external assumptions. The forecast now projects Estonia's economy to contract by up to 5.5% in 2009. However, since the global economy is currently surrounded by high uncertainty, the slump in external demand in November and December 2008 may not be temporary. Thus, it cannot be excluded Estonia's

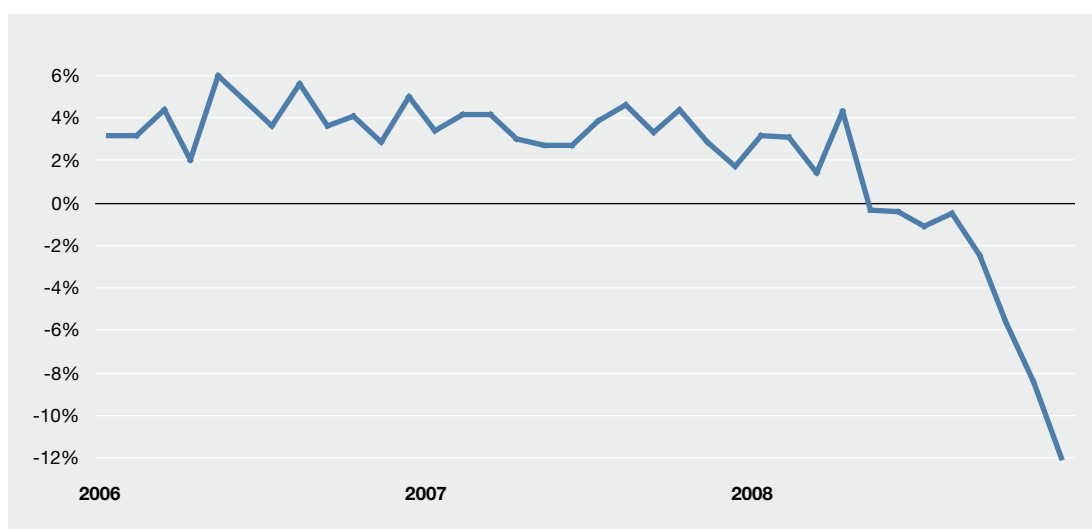


Figure 1. Industrial production growth in the euro area

economic developments will follow the forecast risk scenario, i.e., economic downturn may even reach close to 9%.

Whereas the contraction of the first three quarters of 2008 was primarily caused by weak domestic demand, the fall of the past months of the year was led by a marked drop in goods exports. Preliminary estimates imply that services exports growth rate broadly maintained its earlier level. Industrial output and external trade indicators show that external developments had a very strong impact on Estonia's exports in November. Exports shrank by 19% on November 2007 and preliminary data indicate a further, around 9% drop in December. In earlier months, exports growth was boosted by mineral fuels, metals, timber and timber products, as well as by machinery and equipment, but the exports of all these goods groups declined in November.

The swift economic slump has dampened demand for imported products. Imports statistics indicated a further drop in November and December, showing a decline to 20.3% in November. The imports of transport vehicles (58%) and machinery and equipment (18%) decreased the most. As regards domestic demand, the fourth quarter was characterised

by a marked fall in investment activity. From the point of view of consumption, the purchasing of durable goods shrank the most, as could be anticipated in an economic decline stage.

Since households' income growth was still positive in the fourth quarter, but consumption declined, saving increased to some extent. This partly offset the drop in corporate and public-sector saving. Considering the pace of investment decrease, the external balance improved even more in the fourth quarter. Preliminary estimates show that current account deficit declined to 6% of GDP in the fourth quarter of 2008 (see Figure 2).

Labour market data on the fourth quarter show that unemployment started to rise again, amounting to 7.2%. At the same time, the number of the employed has not decreased much, which give rise to the conclusion that productivity continued to drop in the fourth quarter and companies have been unable to react fast enough to the changing circumstances. However, it should be noted the most extensive labour market changes took place in December and January, thus these developments are not yet fully reflected in the fourth-quarter aggregate statistics. Recent months' data indicate that many enterprises actually have changed course

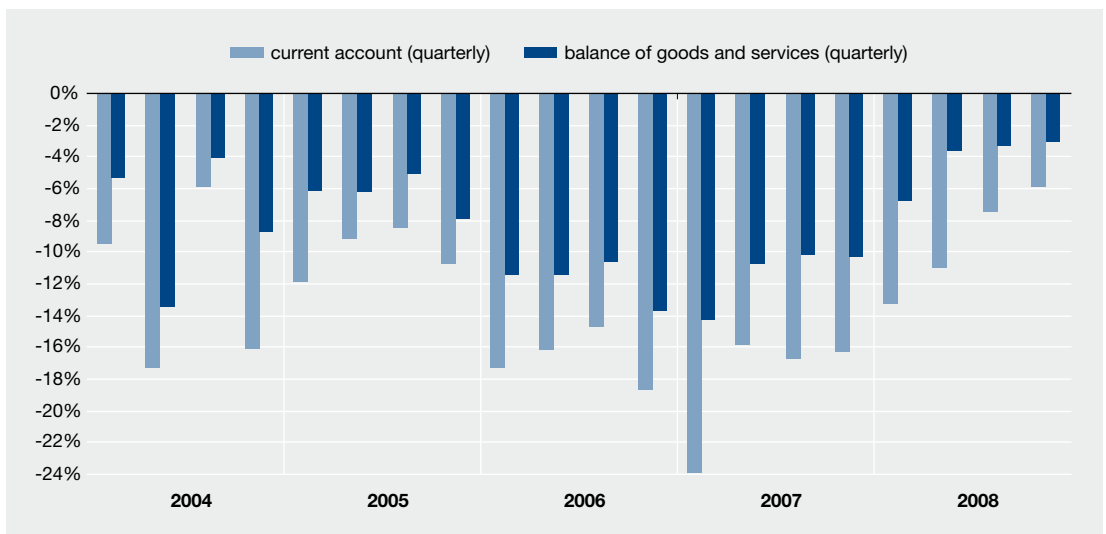


Figure 2. Current account deficit

to cope with the rapidly changing economic environment. Namely, the Tax Board data show employment has started to drop, flexible working types are becoming more widespread, and nominal wages have started to decline in some sectors (e.g., construction).

The economic downturn has also started to impact companies' price setting. The cost of the consumer basket fell in January for the third month in a row, cheapening by 0.6% on December. Compared to January 2008, the price growth rate declined to 4.1%. The abatement of inflationary pressures has been broad-based. In December, import prices cheapened by 1.6% year-on-year. The price drop concerned not only oil but also other goods groups. For instance, the cost of imported food fell 1.1% month-on-month. Declining energy and commodity prices mean foreign trade conditions are becoming more favourable for Estonia.

Domestic inflation data were strongly affected by the previous year's high reference base, since services price growth was record high in January last year. Therefore, January core inflation slowed to 3.5% year-on-year. The goods which underwent the most rapid price hikes

in the period of rapid growth will be the first to become more advantageous for consumers. For example, housing rents cheapened by 16.5% over the past six months. Retail trade is increasingly impacted by the low level of consumers' purchasing sentiment indicators. The discount sales of clothing and footwear, which started at end-2008, continued in January and were far more sizable than a year ago.

Inflation is likely to slow even more. According to Eesti Pank's recent forecast revision, this year's inflation rate will remain below 2% and there will be no price rises next year. In the case of more negative developments, a general price drop cannot be excluded (see also Figure 3).

FINANCIAL SECTOR

The global financial crisis has tightened banks' financing conditions in both Estonia and elsewhere. At the same time, as a result of ECB's monetary policy measures, the 6-month Euribor has dropped to nearly 2% from its October-November highs. It has declined more than 3 pp compared to the October peak. However, the average interest rates of new loans have fallen less swiftly, since banks are raising their

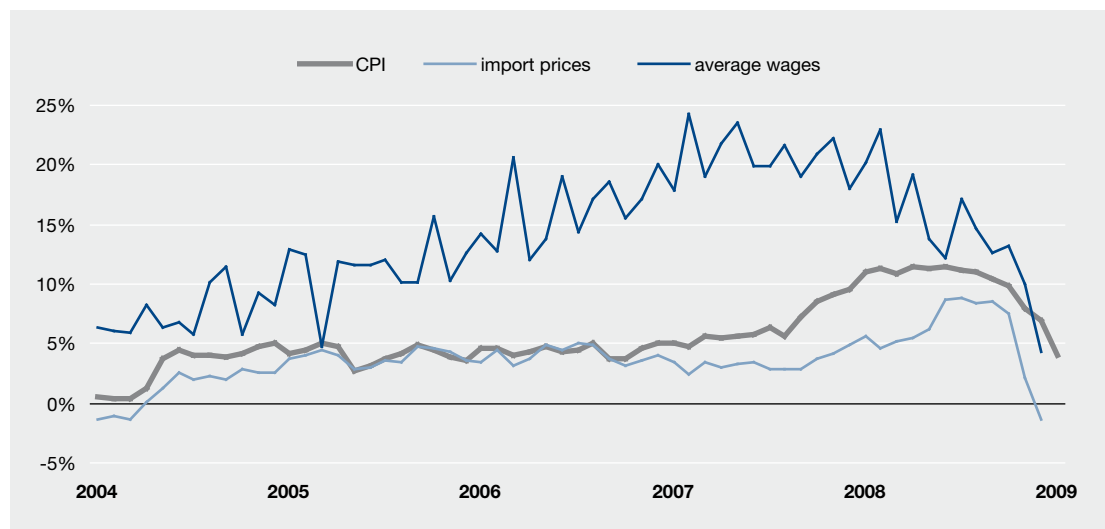


Figure 3. Price and wage growth

risk margins. The interest rate on housing loans dipped from 5.86% in November to 5.35% in December and the interest rate on corporate loans from 6.03% to 5.84%, respectively.

Deposit volume continued to grow in December: corporate and household time deposits increased by 2.1 billion kroons. At the same time, corporate liquidity problems intensified: the growth rate of corporate deposits kept declining and reached -3.7%. Compared to this and also looking at the volume of deposits, it can be said the situation of households is relatively good.

The growth pace of financing portfolios decelerated along with receding economic activity (see Figure 4). The loan portfolio growth rate slowed to 8% in December from 30% recorded in the same month last year. Month-on-month the loan stock even decreased (-2.1 billion kroons, i.e., by -0.8%), mainly as regards corporate loans and leases. In spite of that, the amount of new corporate loans remained relatively stable across all the sectors throughout 2008. Longer-term financing has become somewhat more difficult for companies. Looking into the future it may be assumed that the loan portfolio volume will continue to decrease along with subduing

economic activity. A certain decline in corporate debt burden is completely natural in the current economic situation. This should leave the banks operating in Estonia enough free resources to finance existing good business projects and banks should not become too conservative in their risk assessments.

The volume of loans overdue by more than 60 days increased to nearly 7 billion kroons by end-December. Their share in the loan portfolio rose from 2.5% to 2.9% within a month. The share of loans overdue by more than 60 days is the highest in business services (4%) and the commercial real estate sector (5.3%). In December, banks had to make provisions in the amount of 471 million kroons, which is several times more than in previous months. The large amount of provisions can be explained by the year-end and accounting related to that period. The share of provisions in the volume of loans overdue by more than 60 days grew to 43% in December. The aggregate capital adequacy ratio increased to the level of 18.8%. In Eesti Pank's estimate, both overdue loans and loan losses can be expected to increase this year, but banks' buffers should be sufficient to survive the hard times.

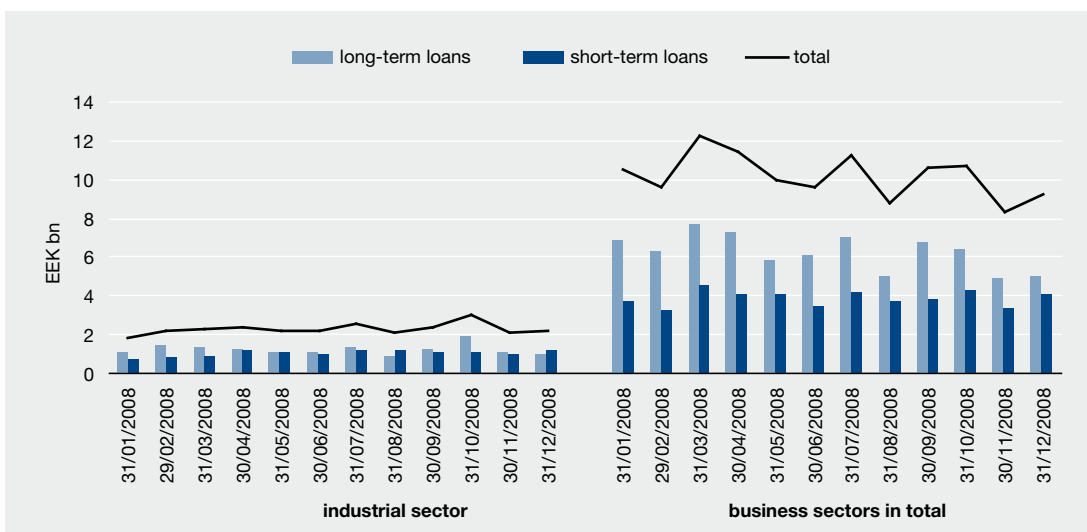


Figure 4. Credit growth