

Eesti Pank
Bank of Estonia



Overview of recent economic developments and the future outlook

16 June 2009

GENERAL EXTERNAL ENVIRONMENT

The most recent economic indicators show the global economic situation has continued to deteriorate over the past months. At the same time, signs referring to slowing downturn and stabilisation are becoming more and more clear. Although macroeconomic indicators are still very low, several leading indicators reveal that confidence is improving. Investors are becoming increasingly more convinced that the crisis has already bottomed out and this has alleviated pressures in global financial markets.

Central banks have considerably lowered their key interest rates, and this has notably reduced also interbank interest rates. The central banks and governments of major economies have taken extensive risk mitigation measures, which have weakened the US dollar exchange rate and contribute to the increase in longer-term inflation expectations. Oil price rise in commodity markets has picked up speed. The cost of oil barrel has soared by over 50% since end-2008 and exceeds again 70 dollars.

The world economy was in deep recession in the first months of the year due to the global crisis. In

the first quarter, year-on-year economic downturn amounted to 2.5% in the USA and to -4.6% in the euro area (see Figure 1). The collapse was even larger in the markets significant to Estonia. For instance, GDP contracted by more than 7% in the first quarter of 2009 year-on-year in Finland and 6.5% in Sweden. Countries have repeatedly downgraded their 2009 forecasts, because economic indicators have been worse than expected.

ESTONIA'S ECONOMY

Domestic and external demand

According to the statistical office, Estonia's GDP went down 15.1% in the first quarter of 2009 year-on-year. This is in line with the base scenario of Eesti Pank's spring forecast, which expects the country's annual average economic downturn to be 12.3%. However, there still prevail large uncertainties as to the time and speed of the recovery of demand.

Industrial output and foreign trade indicators show that external developments have had a very strong impact on Estonia's exports. In the first quarter the exports of goods and services dropped 16% year-on-year. Domestic demand continued to weaken

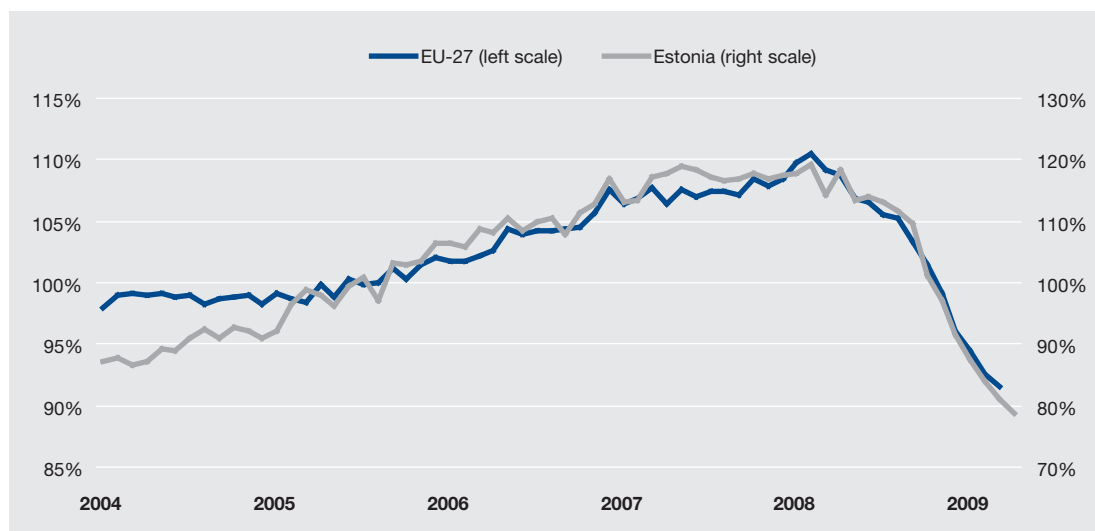


Figure 1. Industrial production growth in Estonia and in the EU (2005=100)

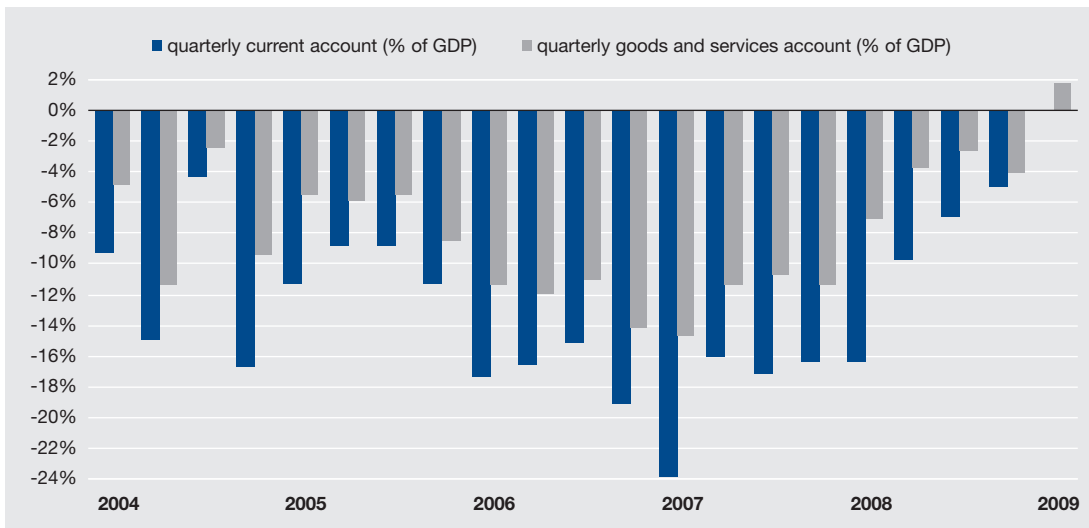


Figure 2. Current account balance

faster than external demand. Fixed capital investment contracted by approximately 27% and the decline in private consumption accelerated to 18%. The purchasing of durable goods shrank the most, which is an anticipated development against the backdrop of the economic recession. The steep decline was broad-based and concerned all the main sectors

Since domestic demand decreased more than income in the first quarter, private-sector saving spurred and Estonia's balance of payments current account moved into balance in the first quarter of 2009 (see Figure 2). A surplus of the goods and services account is rather extraordinary in Estonia, since it is a small open economy where the need for capital will continue to outstrip the volume of domestic savings for quite a long time. This refers to a low in investment activity brought about by the global crisis. Such surpluses were posted in single quarters also in the course of and after the Asian-Russian crisis.

Investment activity was sluggish not because of financing problems, but due to low investment demand. For instance, the amounts received from the EU budget made up 2% of Estonia's GDP, so these would have sufficed to cover a moderate

current account deficit. Direct investment made in Estonia in the first quarter was relatively large in light of the global recession and shows foreign investors continue to be interested in the Estonian economy. The financial account was mainly characterised by a decline in liabilities, thus Estonia's external debt turned out smaller than in the last months of 2008. However, the decline in the debt burden is presumably of one-off nature.

Labour market

The number of the employed started to decline, though very slowly, already in 2008. The employment rate remained unchanged, since the number of working-age people decreased proportionally during the year. In the first quarter of 2009, however, there occurred a very sharp contraction in employment, since many enterprises started reacting to changes in the economic environment. Thus, the number of the employed decreased by 44,000 year-on-year. The number of the unemployed grew by nearly 50,000, because labour supply increased on account of the decline in the amount of the former inactive. The unemployment rate reached an eight-year peak (11.4%) in the first quarter, whereas the employment rate dropped by 4.1 pp (to 58.9%).

By sectors of the economy, relatively more labour force was released in construction, in construction materials and timber industry and in spheres related to real estate. The global crisis has also caused changes in labour migration. More people returned to Estonia in the first quarter of 2009 compared to previous quarters. This added to labour supply even more and tightened competition in the Estonian labour market. The number of the registered unemployed continued to rise in April and May, though at a slightly slower pace than in winter. The estimates of the Estonian Institute of Economic Research also show that people's fear of losing their job started to diminish consistently, reaching in May the level recorded eight months ago.

Among other things, the labour market adjusted in the first quarter also in the form of wages. The average gross monthly wages decreased by 1.5% year-on-year and real wages by 4.6%. This concerned primarily the more flexible components of the wage income (bonuses, incentives) and basic wages have not been curtailed in many fields of activity. Wages decreased the most in financial and insurance activities and construction.

Consumer prices

Due to price pressures exerted by the external economy, the inflation rate exceeded forecasts during the entire 2008. Though the price rise of imported gas added markedly to heating costs at end-2008, the rate of consumer price hikes started falling rapidly last autumn. Consumer prices in Estonia have declined by 2.7% over the past seven months. They reached deflation in May, when the year-on-year price level was 0.3% lower (see Figure 3). Year-on-year price fall should pick up even more speed in the next months.

Estonia is very likely to meet the Maastricht inflation criterion in the last quarter of the year. The longer-term inflation outlook depends to a great extent on energy and commodity price fluctuations in the global market. According to Eesti Pank's spring forecast, prices will continue to decline also in 2010 and 2011. In this connection it is assumed that price decreases in Estonia are caused by both "imported deflation" and wage cuts.

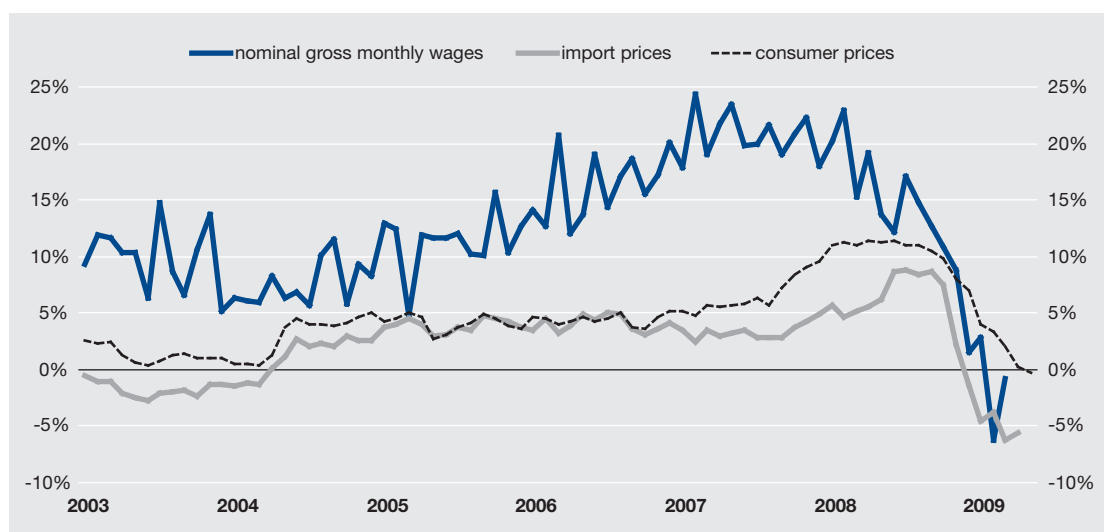


Figure 3. Price and wage growth

General government

Since the expenditure level that evolved during the boom years is no longer sustainable, the government started developing measures to improve the fiscal position. On the expenditure side, the measures did not include just the cancellation of the planned increases, but also the curtailment of current expenditure below the level posted at end-2008. However, it was considered possible to continue to increase expenditures in a few priority spheres (e.g., old-age pensions).

In addition to cutting costs, the government also decided to take steps to boost non-tax revenue, and the raising of consumption taxes in the second half of the year is also an option. As a result of the decisions adopted before May 2009, the consolidated budget deficit should contract to 4% of this year's GDP. In addition, at the end of May the government sent a draft for the second supplementary budget to the Riigikogu. According to the draft, the general government's fiscal position would improve by a total of 3.4 billion kroons. At the same time, the government has set as their goal to find more extra measures to increase the fiscal consolidation measures package to 6 billion kroons. In view of the Maastricht budget criterion, this is the minimum goal.

Due to the sharp economic contraction, the forecast expects this year's tax revenues to be 15% smaller year-on-year. The drop was not yet so extensive during the first five months of the year. This does not mean the first half-year's consolidated fiscal position was better than expected. The general government's expenditures are normally higher at the start of the year than in summer months due to seasonal factors. In addition, very few retrenchment measures came into force at the beginning of the year. Therefore, the general government's first-quarter final consumption expenditure was almost of the same magnitude as in 2008 and the consolidated budget deficit was larger year-on-year. According to preliminary estimates,

this could make up 7-8% of the quarterly GDP. Owing to the cost-cutting measures already taken, the next quarters' deficit will be smaller.

Financial sector

The global financial crisis has tightened banks' financing conditions in both Estonia and elsewhere. At the same time, as a result of the European Central Bank's monetary policy measures, the 6-month EURIBOR dropped below 1.5% in May. It has declined more than 3.5 pp compared to the October peak. However, the average interest rates on new loans have fallen less swiftly, since banks have raised their risk margins.

The annual growth of household and corporate deposits slowed, amounting to 0.3% in May. Although the deposit growth rate decelerated, the volume of domestic real-sector deposits stayed at a level comparable to March, constituting 106 billion kroons.

The increase in household deposit volume refers to the relatively strong financial position of households. The volume of corporate deposits, on the other hand, has decreased both month-on-month and year-on-year.

The annual growth of the portfolio of loans and leasing issued to the real sector receded to 1.3% in April (see Figure 4). The corporate loan and leasing stock was 225 million kroons and the household consumer credit stock 90 million kroons smaller than a year ago. The portfolio has shrunk mainly due to the depreciation of loans, which is bigger than new loans issued.

Although credit market activity has waned, new loans are still being issued. In April enterprises received loans in the amount of 6.5 billion kroons, which is more than in March.

The deterioration of the loan portfolio quickened somewhat and the share of loans overdue by more

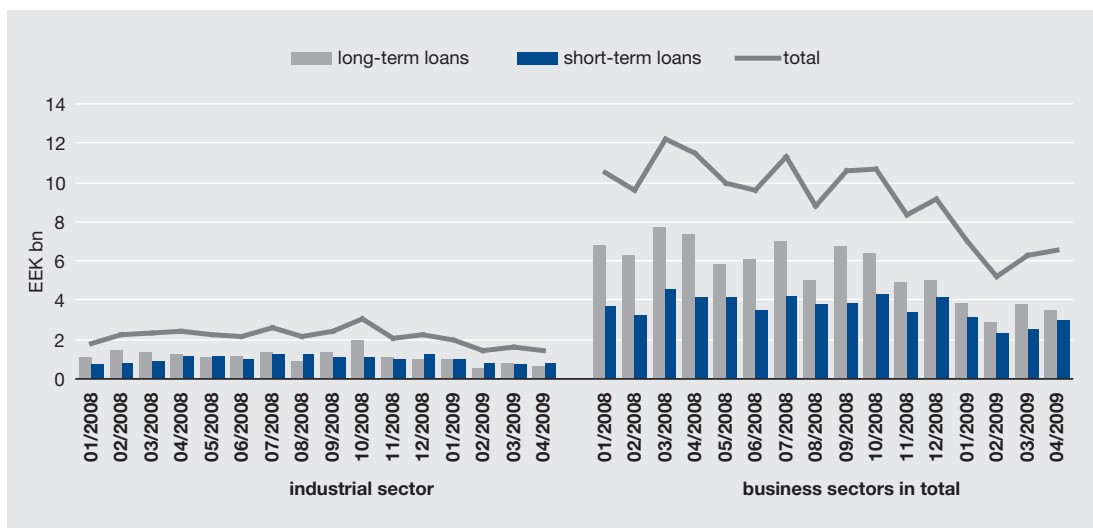


Figure 4. Credit growth

than 60 days increased in April to 5.2% of the entire portfolio. Overdue corporate loans amounted to 6.4% in April. Loan quality is the worst in the construction sector, where overdue loans account for 18% of the entire loan portfolio. The construction sector is followed by the commercial real estate sector, where overdue loans make up 7.9% of the portfolio.

In the case of credit to households, the growth of both overdue housing loans and overdue con-

sumer credit has slowed in recent months. The share of overdue loans increased to 3.3% and 7.7%, respectively, in April.

Irrespective of large provisions banks have made for possible loan losses, the aggregate capital adequacy ratio was just 22% in April. This is a very high indicator in international comparison. It also allows to state that the capital buffers of the banks operating in Estonia are sufficient to cope with forecasted losses on loans.